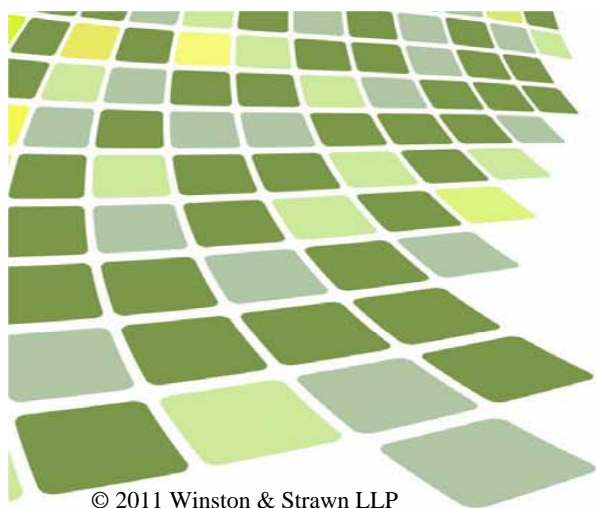


Legal Risk Management Considerations in Plan Investments: What Plan Sponsors Need to Know July 26, 2011



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Overview of Today's Material

- Laying the foundation—a review of fiduciary governance basics
- Understanding risk management and plan investments—comparing and contrasting different structures
- Legal risk management in plan investment agreements



Laying the Foundation—A Review of Fiduciary Governance Basics With an Eye Towards Risk Management



Who's a Fiduciary?

- Under ERISA, the term “fiduciary” is broadly defined to include any person who:
 - Exercises discretionary authority or control over management or disposition of plan assets
 - Renders investment advice for a fee
 - Has discretionary authority or responsibility for plan administration
- Includes those named as fiduciaries in governing documents.
- Includes those who select, appoint, supervise and monitor other fiduciaries.

Risk Management Tip: Know when you are acting as a fiduciary and the extent to which you have effectively delegated your fiduciary duties or retained others to act in a fiduciary capacity.



Proposed Definition of "Fiduciary"

- The DOL is currently proposing a major revision to the definition of the term "fiduciary" that could revise how we think about who is a fiduciary.
- If adopted as proposed, the rule would significantly expand those treated as ERISA fiduciaries when providing non-discretionary advice or recommendations.

Risk Management Tip: Closely monitor timing and final version of these proposed changes.



Fiduciary Duties

Prohibited Transaction Rules

A fiduciary must act:

- Solely in the interest of participants (Duty of Loyalty)
- With the care, skill, prudence and diligence of a prudent person, expert in such matters; sometimes referred to as a "prudent expert" standard (Duty of Prudence)
- By diversifying investments so as to avoid the risk of large losses (Duty of Diversification)
- In accordance with the terms of the plan documents (Duty to Follow the Plan)

- A fiduciary may not cause a plan to enter into a transaction that it knows (or should know) is a transaction with a "party in interest" (as broadly defined in Section 3(14) of ERISA).
- A fiduciary may not engage in acts of "self-dealing" with assets of the plan.
 - May not use assets for own account
 - May not act on both sides of a transaction
 - No "kickbacks"



What is the purpose of “Named Fiduciaries”?

- ERISA requires plans to have one or more "named fiduciaries."
- A "named fiduciary" is either identified in the plan document or appointed pursuant to a process described in the plan document.

Risk Management Tip: Make sure that the named fiduciary is correctly identified in plan investment agreements. Review governing plan documents to confirm named fiduciary designations are as desired.



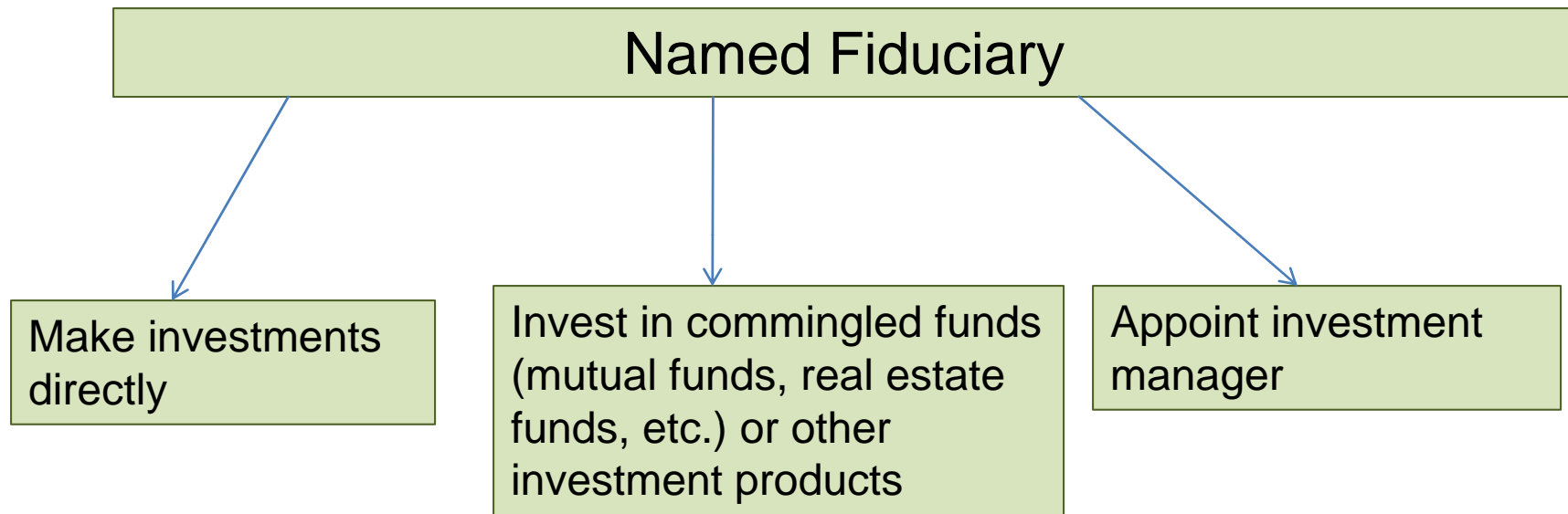
What is the purpose of “Named Fiduciaries”?

- Often committees, rather than board of directors or individuals, are the named fiduciary.
- Plans may have different named fiduciaries for different functions—such as one for administration and one for investment.

Risk Management Tip: Plans can allocate distinct responsibilities to the respective named fiduciaries.



Named Fiduciary Investment Structures



Risk Management Tip: Consider fiduciary risk differential across investment risks to permit clear focus on risk management. Confirm governing instruments support investment structures and desired investments.

The Importance of Named Fiduciary/ Investment Manager Appointments

- ERISA allows named fiduciaries to delegate fiduciary responsibility to an "investment manager" if permitted pursuant to the plan documents.
- Investment managers may also be referred to as "3(38) fiduciaries" based on Section 3(38) of ERISA which defines "investment manager."
- An "investment manager":
 - Must have the power to manage, acquire or dispose of any assets of the plan
 - Must be a registered investment adviser, bank or insurance company
 - Must acknowledge in writing that it is a fiduciary to the plan

Risk Management Tip: Managers of registered investment companies (i.e., "mutual funds") are generally not 3(38) investment managers because they do not manage ERISA plan assets because investment of mutual fund assets is not subject to ERISA.



Named Fiduciary Responsibility for Investment Managers

- If properly appointed, the named fiduciary need not be liable for the acts or omissions of the investment manager unless the named fiduciary:
 - Breaches its fiduciary duties in appointing the investment manager
 - Breaches its fiduciary duties in continuing to retain the investment manager or
 - Knowingly participates in a breach of fiduciary duty by the investment manager or fails to make reasonable efforts to remedy a known breach.

Risk Management Tip: Appointment of a 3(38) manager can be a key risk mitigator.



Named Fiduciary Responsibility for Investment Managers

- Plan fiduciary retains fiduciary responsibility for:
 - Prudent selection and monitoring of investment manager
 - Establishment and content of investment policies and guidelines, including compliance of policies and guidelines with the terms of the plan
 - Diversification of plan assets overall (though manager may also be responsible for diversifying within portfolio managed)



"3(21) Fiduciaries" and Non-Fiduciaries

- It is also possible for the named fiduciary to appoint other advisers who are not fiduciaries or who are fiduciaries but are not 3(38) investment managers.
- Non-fiduciary advisers provide advice or other services to the plan in a non-fiduciary capacity.
- 3(21) fiduciaries (based on Section 3(21) of ERISA where "fiduciary" is defined) may provide advice but not have discretion.
- When appointing a 3(21) fiduciary, the named fiduciary likely may remain liable as a co-fiduciary for the acts and omissions of the 3(21) fiduciary.
- Fiduciary status may differ depending on the specific responsibilities being discharged.

Risk Management Tip: A 3(38) fiduciary is necessarily a 3(21) fiduciary, but a 3(21) fiduciary need not be a 3(38) fiduciary.



3(38) v. (3)(21) Fiduciaries

	Non-Fiduciary	Section 3(38) Investment Manager	Section 3(21)-Only Fiduciaries
Fiduciary to the plan	No	Yes	Yes
Has power to manage, acquire or dispose of plan assets	No	Yes	Generally no
Must be investment adviser, bank or insurance company	No	Yes	Not necessarily
Must acknowledge fiduciary status in writing	No	Yes	Not necessarily
Appointment can limit named fiduciary liability	No—non-fiduciary advisors may imply useful assistance but named fiduciary is the only fiduciary	Yes—3(38) manager implies greater "outsourcing " of risk	No, absent specific contractual undertakings. 3(21)-only fiduciaries imply useful assistance but co-fiduciary responsibility remains

Risk Management Tip: Determine what status is appropriate for a particular engagement based on circumstances, risk tolerances, etc.



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Examples of Fiduciary Roles

- Investment consultant alternative fiduciary roles:
 - Taking on named fiduciary role (e.g. complete outsourcing of fiduciary function)
 - Acting as manager of managers or other discretionary authority
 - Acting as a non-discretionary consultant (fiduciary vs. non-fiduciary)
- Other examples:
 - Transition manager v. broker
 - Securities lending agent?
 - Mutual fund advisor?
 - Hedge fund general partner?



Understanding Risk Management and Plan Investments—Comparing and Contrasting Different Structures

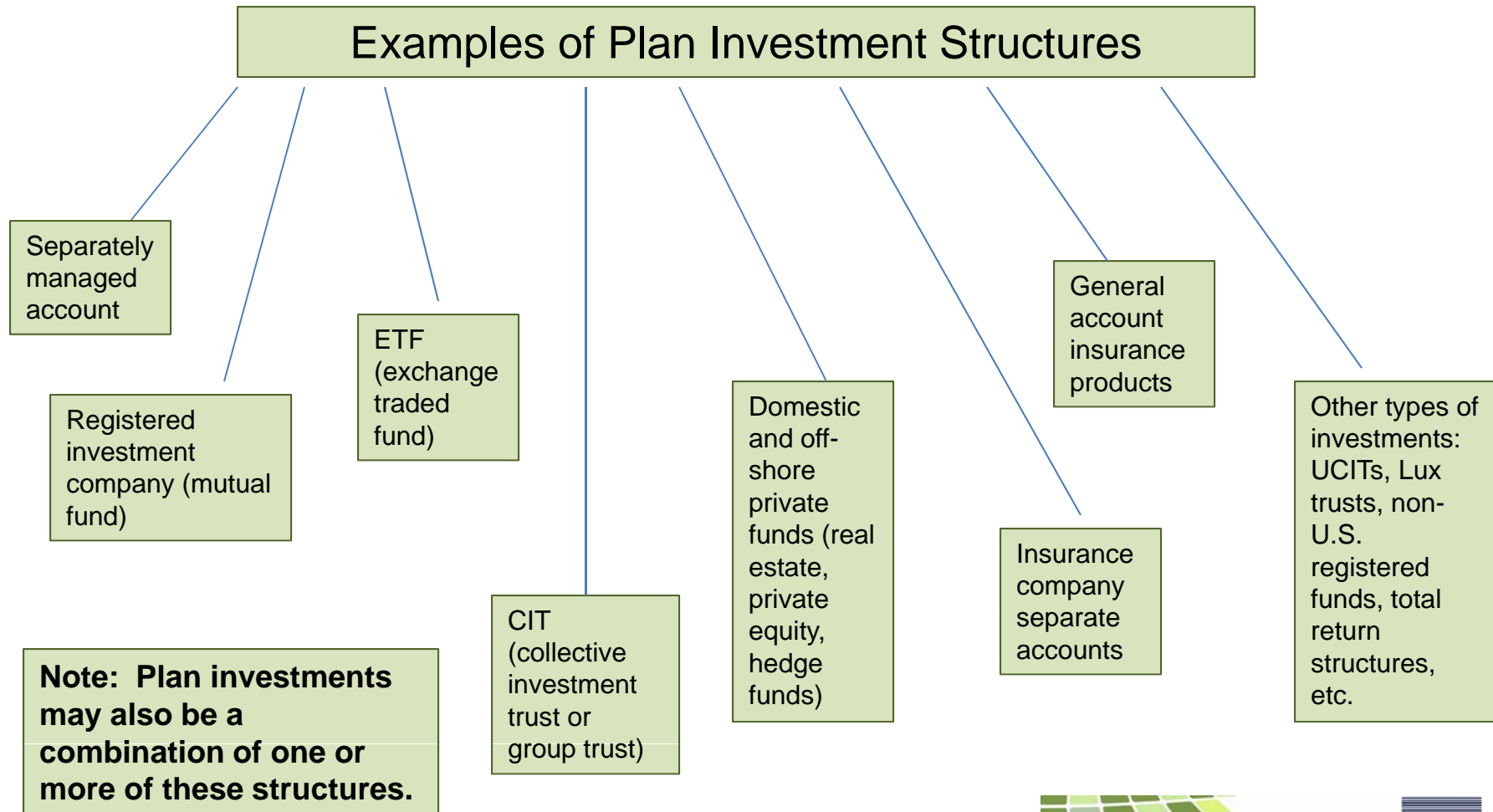


Plan Investment Structures Overview

- From a legal risk management perspective, different investment structures can present different issues and risks for named fiduciaries.
- The same investment strategy may be deployed through different investment structures, requiring different forms and types of documentation.
- The key is to understand the legal and ERISA fiduciary implications of different plan investment structures.



Plan Investment Structures



Separately Managed Accounts

- An account established by the plan's trustee for one plan (or in the case of a master trust, related plans).
- Managed by a 3(38) investment manager (or directly by a named fiduciary).
- Investment portfolio held directly by plan's trustee.
- Available to DB or DC plans.
- Will be subject to ERISA.
- More common among larger plans.

Risk Management Tip: For separately managed accounts, terms of investment management agreement (IMA) are key risk mitigators.



Commingled Funds

- Registered investment companies (i.e., mutual funds)
- Collective investment trusts (including group trusts)
- Private on-shore and off-shore funds
 - "Hedge funds"
 - Private equity funds
 - Real estate funds



Side Bar on Plan Asset Entities

- The assets of a commingled fund may be treated as assets of an ERISA plan subject to ERISA's fiduciary standards.
- Some commingled funds may be "plan assets entities," others may not.
- General rule—if 25% or more of the equity interests in any class of equity interests in an entity are held by "benefit plan investors," the assets of that entity are deemed "plan assets" subject to ERISA.
- Exception for registered investment companies (*i.e.*, mutual funds) and insurance company guaranteed general account products, which are not subject to ERISA, and special rules for collective investment trusts, group trusts and insurance company pooled separate accounts.

Risk Management Tip: Understanding whether a commingled fund is a plan assets entity (or the circumstances under which it could become one) is key to understanding risks of investment in the commingled fund.



Implications of ERISA plan asset status

	Plan Asset Commingled Fund	Non-Plan Asset Commingled Fund
Manager can be appointed as "3(38)" investment manager	Yes	Not unless additional IMA is entered in conjunction with investment in commingled fund
Applicable standard of care	ERISA's fiduciary standard of care	Often lower standard, depending on the type of entity and its applicable laws and contractual assurances
ERISA's prohibited transaction rules apply to investment and operation of the fund	Yes	Generally not
Form 5500 Schedule C/fee and comp disclosures required	Yes	Yes
Section 408(b)(2) fee and comp disclosures required	Yes	Varies based on type of fund



Registered Investment Companies/Mutual Funds

Key Characteristics	
Managed by investment advisor (and/or sub-advisors) and subject to oversight by mutual fund board.	A fund often established as a trust for commingling the investment of the assets of unaffiliated plans and potentially other types of investors.
Available to DB or DC plans.	Not subject to ERISA, but subject to comprehensive SEC Investment Company Act and other SEC rules.



CITs and Group Trusts

Key Characteristics

Usually a trust established to commingle the investment of the assets of unaffiliated U.S. tax-qualified retirement plans; generally not eligible for other types of investors.

CITs are regulated by the OCC or state banking regulators. Non-CIT group trusts are usually not subject to these banking laws.

CITs are subject to the exclusive management of a trustee but may have an investment advisor act as sub-advisor.

For group trusts that are not CITs, the trustee may serve only as a custodial trustee and the investment manager may have full discretionary management authority.

CITs available to DB or DC plans. Non-CIT group trusts are used in DB plans and may have more limited availability for defined contribution plans.

Likely will be subject to ERISA if the trust has any ERISA investors.



Private Funds—Domestic and Offshore

Key Characteristics

<p>Domestic funds typically partnership or LLC usually investing the assets of unaffiliated plans and other types of U.S. and non U.S. investors. Offshore funds can take different forms, such as corporations, etc.</p>	<p>Managed by a General Partner (in the case of a LP) or Managing Member (in the case of an LLC).</p>
<p>“Hedge” funds, private equity funds, real estate funds and even traditional investment mandates may all take this form.</p>	<p>Depending upon the results of the 25% test, may or may not be plan asset entities.</p>
<p>Can have multiple investment funds and classes, each with different rights and features.</p>	<p>More commonly found in DB plans (more limited availability to Dc plans) for SEC reasons.</p>



Insurance Products

Key Characteristics	
"General account" consists of the assets of insurance's general account, subject to the insurer's general creditors the event of the insurer's insolvency. General account assets typically managed by insurance company.	"Separate account" consists of assets owned by the insurance company for the benefit of the plan, established under state insurance law so assets are not subject to claims of insurer's general creditors. Often managed by an investment advisor
Managed by insurance company.	Separate account products may include or have non-insurance company subadvisors.
Current general account products are typically guaranteed investment products and are not subject to ERISA.	Separate accounts products may be fully guaranteed (and not subject to ERISA) or variable (and subject to ERISA).
Available to DB or DC plans.	State insurance regulators regulate the issuance of these products.



Stable Value Investment Products

General Account	Separate Account	Synthetic GIC
Guaranteed product	May be fixed or variable	Variable
Assets held by insurance co. subject to claims of the insurance co. creditors	Assets held by insurance co. for the benefit of the sep. acct. holder; intended NOT to be subject to insurance co. creditors	Assets held by plan trustee
Assets generally not plan assets	Could be plan assets	Plan assets
Non-benefit responsive withdrawal provisions may be restrictive or subject to market value adjustment	Non-benefit responsive withdrawals more liberal than general account, but still subject to market value adjustment	Non-benefit responsive withdrawals more liberal than insurance products, but still subject to market value adjustments

Risk Management Tip: These contracts have non-standard terms and negotiated terms.

Plan Investment Structures Differences

- Because they are different, different investment structures have different legal considerations and different legal risks.
- Forms of legal documentation
- Forms of disclosures
- Legal owner and/or custodian/holder of assets
- Withdrawal, redemption, liquidity rights
- Applicable law
- Standards of care, liability and indemnification provisions



Plan Investment Structures Differences

- Different ERISA fiduciary considerations, such as:
 - Some structures will operate in accordance with an ERISA fiduciary standard of care; others may not.
 - An ERISA fiduciary standard of care applies to the investing fiduciary's selection and monitoring of the investment structure in any event.
 - May be able to modify standard of care contractually.
- Ability to delegate fiduciary duty to 3(38) investment manager may be available in some structures and not others
 - Without effective delegation, plan fiduciary may not have delegated their fiduciary duties.
 - Not all "plan assets" commingled funds include provisions to support delegation to 3(38) investment manager.

Risk Management Tip: Fiduciary delegation and standard of care may need to be negotiated with commingled fund managers.



Legal Risk Management in Plan Investment Agreements

Overview

- As discussed, documentation will vary by investment structure, including:
 - Investment consultant/advisory agreements
 - Investment management agreements
 - CIT and group trust agreements
 - Group annuity contract or separate account agreement
 - LPs or LLC agreements or subscription agreements
 - Side letters
- As with investment structures, plan investment agreements can vary from one provider to the next based on services provided, risk tolerances, etc.

Risk Management Tip: Well-structured and well-negotiated plan investment agreements are another effective risk management tool for plan fiduciaries.



Investment Advisers/Consultants

- Clearly define scope of services.
- Consider "to what extent" is the service provider a fiduciary.
- Consider whether appropriate for service provider to be 3(38) for any services provided.
- Understand if the named fiduciary is sole fiduciary or a co-fiduciary for services provided.
- Monitor impact of changes in definition of fiduciary.
- Address fiduciary standard in RFP.
- Address standard of care and limits on liability even if non-fiduciary.



Investment Advisers/Consultants

- Include "diligence" provisions from template IMAs, as appropriate, such as:
 - Standard of care for recommendations
 - E&O and insurance
 - Registered IA status
 - Etc.
- Carefully review indemnification and limits on liability.
- Consider template investment advisory agreement when multiple engagements are contemplated.
- Consider including key terms in RFP process.

Investment Management Agreements

- **Develop standard IMA**
 - Helps promote uniformity of terms across investment management relationships.
 - Builds in legal terms that protect plan participants and plan fiduciaries.
 - Can reduce cost and negotiating time when retaining new investment service providers.



Examples of Key Risk Management Terms

- Appointment (and acceptance) as 3(38) investment manager.
- Ability of the manager to delegate/assign and responsibility of the investment manager to delegees and assignees.
- Responsibility to bring or defend litigation.
- Insurance coverage (*e.g.*, ERISA fiduciary liability coverage) and ERISA bond.
- Ability of the manager to expose assets outside of the specific account under its management (may be necessary for some mandates).
- Ability of the manager to invest in its own commingled funds.
- Conflicts of interest



Investment Management Agreements

■ Valuation

- Identifying who will be responsible for valuation (investment manager v. trustee).

■ Reporting and Disclosure

- Reporting of events material to the investment provider's management of the assets.
 - ◆ Important for duty to monitor investment service provider.
- Reporting and disclosure required by regulation.
 - ◆ Form 5500
 - ◆ Section 408(b)(2)
 - ◆ 401(k) participant disclosures



Investment Management Agreements

- Indemnification and Limitations on Liability
 - Often heavily negotiated provisions in any investment management relationship.
 - ERISA places limits on indemnification—a plan may not agree to an arrangement under which the plan would indemnify a fiduciary for breach of fiduciary duty.

Risk Management Tip: Highlighting any indemnification requirements in the RFP or manager interview process may avoid surprises and save negotiating time later on in the process.



Investment Management Agreements

■ Fees

- Amount and structure of the fee
 - ◆ Percentage of assets under management.
 - ◆ Performance or incentive fee
 - DOL advisory opinions place conditions incentive fees.
 - Objective basis for determining fee, ability for manager to use discretion to affect its own fee.

Risk Management Tip: Clear documentation of due diligence and negotiation of the investment management fee is a helpful risk mitigator.



Commingled Funds

- Different than negotiating IMA for a separate account, but many principles the same.
- Develop "hot issues" list
 - Should incorporate key terms from IMA.
 - Provides a checklist or road map when evaluating potential investments in pooled vehicles.
 - Helps promote uniformity of terms across investments in pooled vehicles and between investments in commingled funds and separate accounts.



Commingled Funds

- Consider effect of non-uniformity between separate account terms and commingled fund terms.
 - If the terms of a commingled fund investment are different than the terms of a separate account investment, consider whether the difference in terms is justified by other considerations (e.g., cost, structure, etc.).

Risk Management Tip: To the extent you agree to terms that are different, document your determination that the difference is justified. Make this determination part of the decisionmaking process, not after-the-fact as a concession.



Commingled Funds

- Standard of care
 - May depend on the type of commingled fund—plan assets fund v. non-plan assets fund.
 - May be possible to bring the standard of care in line with separate account standard of care through side letter provisions or amendments.
- Indemnification
 - Non-ERISA commingled funds tend to have more liberal indemnification and limitations of liability of the investment manager.
 - ERISA commingled funds at least have ERISA standard of care and limits on indemnification.
 - Could be a subject of a side letter.

Risk Management Tip: Agreeing to indemnification or limits on liability is not per se imprudent (according to DOL Adv. Op. 2002-08A), but is best considered by the fiduciary as a part of investment process.



Commingled Funds

- Valuation
 - Consider process for valuing underlying assets
 - ◆ Does an independent trustee or custodian determine value?
 - ◆ What is the valuation policy?
 - ◆ Will there be hard-to-value assets?
 - ◆ Daily, monthly or less frequent values?
 - Consider available reporting transparency and ability to audit or review valuation process.
- Fees (see discussion for IMAs; many of the same considerations)
- Consider side letters and potential for disparate treatment across investors.



Commingled Funds

- **Notice rights (similar to IMA)**
 - Changes in management
 - Amendments to governing document
 - Changes to investment guidelines
- **Withdrawal/redemption rights**
 - Frequency of withdrawals/redemptions
 - Likelihood of restrictions on withdrawals—"gating," illiquid securities, etc.
 - In-kind distributions



Additional Materials

Plan Investment Structures Comparative Chart

	Separately Managed Account	Collective Trust	Non-CIT Group Trust	U.S. Mutual Fund	Domestic LP/LLC	Offshore Fund	U.S. Insurance Contract
Form of Legal Documentation	Investment Management Agreement and Investment Guidelines	Trust Agreement and Adoption or Other Agreement	Same as CIT	Application and Fund Agreements	Partnership/ Operating Agreement and Subscription Agreement	Depends upon structure, can vary	Group Annuity Contract
Additional Disclosure Documents	N/A	Not always applicable. Some use fund descriptions and fund fact sheets.	Same as CIT <u>OR</u> Domestic LP/LLC	Prospectus and Statement of Additional Information	Private Placement Memorandum	U.S. PPM and as required by offshore jurisdiction.	Often not applicable
Owner/holder of assets	The plan's trustee/ custodian	Collective Trust's trustee/ custodian	Same as CIT	Mutual fund trustee/ custodian	Typically, custodian or prime broker in lieu of custodian	Typically, custodian or prime broker in lieu of custodian	Insurance company



Plan Investment Structures Comparative Chart

	Separately Managed Account	Collective Trust	Non-CIT Group Trust	U.S. Mutual Fund	Domestic LP/LLC	Offshore Fund	U.S. Insurance Contract
Standard of Care	ERISA standard of care and as set forth in IMA	ERISA standard of care and as set forth in Trust Agreement	Same as CIT	Not subject to ERISA, but subject to investment Company Act and SEC rules	Not subject to ERISA if under 25%. Standard of care often lower than ERISA standard, and as set forth in fund documents	Not subject to ERISA if under 25%. Standard of care often lower than ERISA standard, and as set forth in fund documents	Not subject to ERISA if general account; may be subject to ERISA if separate account; and as set forth in group annuity contract
Ability to delegate to 3(38) manager	Yes	Yes, but may not be automatic	Yes, but may not be automatic	No (absent separate IMA)	Potentially (if a plan assets fund)	Potentially (if a plan assets fund)	Potentially, for an insurance company separate account



Plan Investment Structures Comparative Chart

	Separately Managed Account	Collective Trust	Non-CIT Group Trust	U.S. Mutual Fund	Domestic LP/LLC	Offshore Fund	U.S. Insurance Contract
Sponsor-initiated withdrawal restrictions	N/A	Varies	Varies	Generally not restricted	Varies; lock-ups and other withdrawal restrictions not uncommon	Varies; lock-ups and other withdrawal restrictions not uncommon	Restrictions not uncommon; may be subject to market adjustments
Applicable Law	ERISA, IRS, SEC, applicable foreign laws, etc.	Banking laws, ERISA, IRS, SEC (exemptions, regulation of advisors, etc.), applicable foreign laws, etc.	ERISA, IRS, SEC, applicable foreign laws, etc.	(Not ERISA) SEC/Investment Company Act, IRS, applicable foreign laws, etc.	Applicable state laws, IRS, SEC, (ERISA if over 25%), applicable foreign laws, etc.	Applicable foreign laws, SEC, (ERISA if over 25%), etc.	State insurance laws, ERISA (if separate account), applicable foreign laws (Insurance tax rules apply.)



Key negotiating terms for effective risk management

✓ Scope of fiduciary duties, if applicable (3(38) v. 3(21))	✓ Standard of care (especially in non-fiduciary agreements or non-plan-assets commingled fund)
✓ Proper appointment and acceptance of 3(38) status, if applicable	✓ Indemnification and limits of liability
✓ Limitations on delegation and assignment	✓ Responsibility/obligations for litigation
✓ Valuation	✓ Reporting and disclosure (including rights to notice of specified events)
✓ Responsibility for compliance with prohibited transaction rules and exemptions	✓ Insurance coverage
✓ Withdrawal/redemption rights (for commingled funds)	✓ Fees (and fee disclosures/transparency)



Investment Management Agreement "Laundry List" of Other IMA Provisions

✓ UBTI provisions	✓ Authority/capacity, licenses and registrations, good standing
✓ Prohibited transaction compliance, compliance with exemptions	✓ Brokerage (best execution, soft dollar, directed brokerage)
✓ Proxy voting	✓ Appropriate termination provisions
✓ Confidentiality	✓ Audit provisions
✓ Allocation of investment opportunities	✓ Amendment provisions



Back to Basics: 5 Key Questions for Plan Sponsors

- Who has the authority to appoint the service provider?
- Are the parties to the agreement correct?
- Who will pay the investment service provider? (The plan? The plan sponsor?)
- Is the investment authorized by investment guidelines and plan documents?
- Have there been corporate or other changes that require revisions to plan governance documents or structures?



Questions?



Thank you!

