

## PENSIONS

---

### ARTICLE

#### **CAREFUL PRUNING - TRUSTEES SHOULD BE THINKING ABOUT KEEPING CLOSER CONTROL OVER THEIR INVESTMENT IN ALTERNATIVES**

In a nutshell:

- ◆ in recent years many pension trustees have made substantial investments in private equity and hedge funds;
- ◆ the credit crunch and the Madoff case have caused trustees and their advisers to think more carefully about alternative fund investments; and
- ◆ governments and regulators are looking more closely at the risks and the regulation of alternative funds.

Over the last ten years or so, and prior the collapse of Lehman Brothers, many pension trustees had increased their allocations to alternative assets and made some substantial investments in both private equity and hedge funds.

Since the implementation of the Pensions Act 1995, pension trustees have had a statutory duty to take advice from a competent investment adviser before making any investment decisions. Consequently, most trustees now have one or more advisers.

However, the last 18 months have been difficult times for alternative asset funds. The combination of the credit crunch and the Madoff case have caused many pension scheme trustees and their advisers to think more carefully about the level of allocation they are making to alternative funds as well as the amount of due diligence (both commercial and legal) which needs to be undertaken before they make further alternative fund investments.

#### **RESTRUCTURING**

The credit crunch has exposed the difficulties facing a number of alternative funds, many of which have, in the last year or so, undergone some form of restructuring. Certain private equity funds (particularly the 2005-7 vintage funds) appear to have undertaken overleveraged transactions - consequently, many portfolio companies are finding trading conditions difficult and are struggling to repay their debt. There is concern over obtaining "proper" valuations of portfolio companies, which in many cases have been substantially written down. With the lack of acquisition activity, there have been few realisations and so cash flow for some pension schemes is a problem; a number seem to have "overcommitted" and are requesting managers not to issue drawdown notices.

Many hedge funds have also had credit crunch related difficulties -with the outcome of their trading strategies in a volatile market leading to problems in establishing valuations, as well as overleverage issues.

In addition, the fraudulent "Ponzi scheme" put in place by Bernard Madoff, which is said to have taken in more than US \$64bn over two decades, has created global ripples. Mr Madoff himself only ran managed accounts but there were a number of other managers who operated feeder funds, including UCITS (Undertakings for Collective Investment in Transferable Securities) vehicles, which invested their assets with him. The 4,800 or so investors in Madoff products, based across the world, included a number of pension schemes.

It is fundamental that the trustees of a pension scheme should understand the nature of the product which is being offered. They need to be clear about the investment policy and the anticipated returns. If, despite market movements, the previous return has been abnormally smooth (as was the case in Madoff) or if the returns being offered are, in current market conditions, unrealistic, further investigation is required. It can be useful to examine other funds with a similar investment policy. A careful analysis of the risk profile and taxation implications (if any) of the product should also be undertaken.

Mr Madoff's supposed refusal to disclose his investment strategy and/or to meet with investors who wanted a greater understanding of his investment policy should have rung alarm bells.

Enquiries should also be made about side letters and investors should try and obtain "most favoured nation" status (ie ensuring that they do not have less favourable terms). Ideally side letters should be disclosed before closing- not afterwards as this leads to a double negotiation of terms which can be both time consuming and expensive.

#### **CHECKS TO BE MADE**

Trustees (or those advising them) need to look closely at the credentials of the manager and the management team. Enquiries should be made about their previous experience and references taken orally. Checks should be made as to whether the management team are approved by the Financial Services Authority (FSA) (or other relevant regulator) and questions asked as to whether any complaints have been made against them or any investigations undertaken.

Consideration should be given to the level of management fees and carry/performance fees and other commercial terms (such as redemption rights and gates in hedge funds or early termination provisions in private equity funds) - are they in line with those imposed by managers of similar assets? There has been considerable movement in the private equity executive market and significant generational change is occurring. Key man provisions are vital - will the people promoting the fund be tied in to undertake an appropriate level of management?

Some comfort can usually be taken by looking at the third parties involved with the fund. Checks should be made on others involved in the arrangements. It is helpful if they are regulated entities and there is an independent prime broker, custodian undertaken on the administrator and other back office providers. Respectable directors (who really are taking a key role in central management and control) are important. Details of the auditors should be reviewed. This was a key indicator of a problem in the Madoff case. The FSA will approve the auditor of a regulated business, although there are no restrictions on, or approval required for, the auditor to the fund itself.

#### **TRANSPARENCY**

Pension trustees or their advisers should consider carefully the quality and frequency of information that managers agree to provide. They should make sure that the reports reflect the stated investment strategy and the returns that have been made. (Apparently, they did not in Madoff.) Although most hedge fund managers offer monthly net asset value calculations, some are now moving to daily reports and are providing details of the sources of losses or gains. There is, however, a question as to whether pension trustees want, or can cope with, more information. They may have to pay consultants more to analyse and report on the additional information, leading to greater administrative fees being charged.

Many people are asking whether in future, pension trustees should opt for managed accounts, over which they have more control, rather than a blind pool, to invest in alternative assets. The term "managed accounts", however, can cover a variety of arrangements from pledge funds to individual discretionary accounts or even advisory arrangements. It is questionable whether these options are realistic for pension schemes which may not have the resources to monitor such accounts properly. It may be better to run the risk of a blind pool with the "right" manager.

#### **HIGHER STANDARDS**

The European Commission reacted quickly to Madoff with the publication at the end of April 2009 of the proposed Alternative Investment Fund Managers Directive.

The Directive will introduce Europe-wide regulation of alternative fund managers themselves (but not the funds they manage) and a Europe-wide private placing regime for alternative funds. Once the Directive is finalised it is expected to come into force within two years. In that intervening period the "Lamfalussy approach" will be used to create more detailed rules/provisions building upon some of the more high level provisions in the Directive.

The Directive will result in higher standards for authorisation of EU fund managers as well as more rigorous regulatory capital tests and additional reporting and transparency requirements. However, there is still debate about many potential provisions which will materially affect the promotion and operation of private funds. In particular, there is concern about whether non-EU funds will be capable of being marketed in various countries within the EU. Consequently, in future EU based pension schemes may be denied access to certain non-EU funds.

The landscape for alternative fund investments is changing. It remains to be seen whether pension schemes and other institutional investors will use the current situation to try, either individually or together, to negotiate better terms.

#### **CONTACT DETAILS**

If you would like further information or specific advice please contact your usual Macfarlanes contact or:

**BRIDGET BARKER**

DD: +44 (0)20 7849 2495

[bridget.barker@macfarlanes.com](mailto:bridget.barker@macfarlanes.com)

**MACFARLANES LLP**  
**20 CURSITOR STREET LONDON EC4A 1LT**

T: +44 (0)20 7831 9222 F: +44 (0)20 7831 9607 DX 138 Chancery Lane [www.macfarlanes.com](http://www.macfarlanes.com)

This note is intended to provide general information about some recent and anticipated developments which may be of interest. It is not intended to be comprehensive nor to provide any specific legal advice and should not be acted or relied upon as doing so. Professional advice appropriate to the specific situation should always be obtained.

Macfarlanes LLP is a limited liability partnership registered in England with number OC334406. Its registered office and principal place of business are at 20 Cursitor Street, London EC4A 1LT. The firm is not authorised under the Financial Services and Markets Act 2000, but is able in certain circumstances to offer a limited range of investment services to clients because it is regulated by the Solicitors Regulation Authority. It can provide these investment services if they are an incidental part of the professional services it has been engaged to provide. © Macfarlanes January 2010