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Fund Investing: What to Ask for and How to Ask for It

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Pension plans sponsors can negotiate a better balance between the needs and interests of the fund manager and those of the investor.

Any lawyer will tell you that the party drafting a contract has an automatic advantage. They have the opportunity—and in most cases will use this opportunity—to choose wording that favors their interests. How does this rule apply to investments? An investment in a private equity fund or a hedge fund offers a timely example. According to recent press reports, 2006 is expected to find more middle and smaller size pension plans subscribing for interests in these funds in hopes of boosting their annual returns.

Each subscriber to a fund is required to sign a contract in which it agrees to the terms of the investment, terms that are found in the fund's operating agreement and sometimes in its private placement memorandum. For simplicity's sake, we assume here that the fund is a limited liability company (LLC). However, the same comments would apply if the fund were a limited partnership.

When the investor is an employee benefit plan, the plan's fiduciary must make a determination that the investment is prudent. No plan would invest without a full understanding of the economics and financial risks inherent in an investment. But many plans do not give the same attention to the actual terms by which they become a member of the fund.

Pension plans, like many other institutional investors, may be unaware that many of these terms may impact the profitability and legality of their investment and, most important, are open to negotiation. This article highlights several terms that with some revision will promote a greater balance between the needs and interests of the fund sponsor or manager on the one hand and those of the investors or members on the other hand.

Our illustrations come from fund documents we have reviewed. They cover the topics of reports to members, the valuation of fund assets, the manager's discharge of its fiduciary duties, redemption or withdrawal procedures, the distribution of side letters, use of most favored nation provisions, and specific Employee Retirement

Keywords: pension plans; institutional investors; hedge fund; private equity fund; fiduciary; investment

DOI: 10.1177/0886368706289996



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1. The theory on which the Department of Labor (DOL) would find that the fee structure is a prohibited transaction is that under some circumstances the manager could use the authority that makes it a fiduciary to increase the fee payable to itself or to impact the time at which paid. The opinion letters issued by the DOL are DOL Opinion Letter (Op. Ltr.) 99-16A (Mount Lucas Management Corporation, Dec. 9, 1999); DOL Op. Ltr. 89- 31A (Alliance Capital Management, L.P., Oct. 11, 1989); DOL Op. Ltr. 86-21A (Batterymarch Financial Management, Aug. 29, 1986); and DOL Op. Ltr. 86-20A (BDN Advisers, Inc., Aug. 29, 1986).

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