



**AMERICAN BENEFITS**  

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**COUNCIL**

**Statement of L. Randolph Hood, CFA, Prudential Financial  
on behalf of the American Benefits Council**

**Advisory Council on Employee Welfare and Pension Benefit Plans Working Group  
on Plan Asset Rules, Exemptions and Cross-Trading**

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*Introduction*

On behalf of the American Benefits Council, thank you for this opportunity to comment on the "significant participation test" under the Department of Labor's plan assets regulations. Although recently passed legislation has updated this regulation, there still are important issues that the Department of Labor may address through regulation. In particular, the Department should consider raising the threshold for "significant participation" from 25% to 50%. This change would allow plans additional access to invest in certain alternative asset investments — including private equity, real estate and hedge funds — which play an important role in diversifying investment portfolios, reducing portfolio risk, and potentially enhancing investment return. I would like to discuss today why ERISA-covered plans should have access to these alternative asset classes and how the current arbitrary 25% threshold significantly limits plans' access to the best alternative asset investment opportunities.

I am here representing the American Benefits Council, a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to employee benefit plans covering more than 100 million Americans." At Prudential Financial, I currently serve

in a plan sponsor role, as senior investment manager responsible for Prudential Financial's 16 billion dollar Domestic Employee Benefit Plans. Before this, as senior investment manager for Prudential's 45 billion dollar financial services business, I was responsible for the insurance company's asset-liability matching. I also have extensive experience in equity investments and tactical asset allocation. Altogether, I have advised financial institutions for about twenty-eight years.

### *Role of Alternative Investments in Plan Investing*

Generally, "alternative investments" means investments other than traditional stocks and bonds. Alternative investments are typically considered to include —

- *Private equity funds*, such as venture capital funds, which invest alongside management in new companies; mezzanine funds, which provide additional capital to growing or expanding businesses; and buy-out funds, which specialize in investing in established businesses.
- *Hedge funds*, which employ various active investment strategies to meet specific objectives, such as seeking superior absolute investment return or minimizing volatility while earning reasonable return. These strategies are designed to capture return opportunities by taking positions that traditional stock and bond investors are not willing to take or are otherwise restricted from taking.
- *Real estate funds*, including investments in real property, oil and gas, and infrastructure.

In addition, in recent years, *funds of funds* have become an often-preferred approach to alternative investments. A fund of funds invests in other funds, either as a new investor or — in the case of *secondary funds* — in existing funds with established

portfolios. Fund of funds structures allow investors to achieve greater diversity among managers and investment strategies, which helps to control investment risk.

In recent years, institutional investors — including foundations, endowments, state and local governmental pension funds, and corporate pension funds — have increased the portion of their investment portfolios allocated to alternative investments. There are important reasons for this trend.

First, all categories of alternative investments, including real estate, private equity funds and hedge funds, are desirable because their returns and risks are not highly correlated with the returns and risks of traditional equity and fixed income securities. By investing in alternative asset classes, plans may be able to diversify plan investment returns and also reduce overall portfolio volatility.

Second, and equally important, alternative investments are used with the expectation that they will be able to outperform equities and fixed income over time. And, there is historical evidence that alternative asset investments can provide returns superior to traditional equity and fixed income investments.

Further, alternative assets, especially hedge funds, may be able to support particular plan investment objectives more effectively than traditional investments, in some situations. Before I became the Prudential domestic plans' general investment manager, I worked for Prudential Insurance Company in its asset/liability matching group. In my view, an important consideration in whether a plan will remain fully funded is careful attention to the matching of plan investments to the plan's liabilities. This approach depends on the type of liabilities under the plan. For example, traditional defined benefit pension liabilities are essentially annuities, a liability paid out over time, which may be matched with traditional long-duration fixed income investments.

Cash balance liabilities are quite different. Cash balance benefits are typically payable in lump sums, rather than as a steady stream of annuity payments over a retiree's lifetime. Cash balance liabilities are typically credited annually at rates greater than money market rates, yet they do not have the usual interest rate sensitivities that could be matched by investing in longer duration fixed income investments. The balances in cash balance plans only go up, never down, and have very little volatility in the rate of growth. Fixed income instruments and common equities are poor matches for cash balance liabilities. These liabilities are, however, well matched by absolute-return, or market neutral, hedge fund strategies, making such funds particularly attractive to those sponsors who have cash balance plans.

Although alternative investments can be very helpful in the management of pension plan assets, the successful employment of these strategies requires diligence in the selection and monitoring process. In this respect, there are two key issues for pension plan managers — access and ability to diversify. In particular —

- Access to the very best alternative asset managers is more important than for traditional investments because active management and specialized expertise are critical to the success of alternative investment strategies.
- Many alternative investment strategies are subject to capacity constraints because the strategy becomes unworkable with large amounts of capital. The best managers are often faced with excess demand and investors must compete for access. Many of the best funds are closed to new investors. When they do open, they are often likely to accept assets from current investors with whom they already have a relationship.
- Alternative investments typically exhibit a greater dispersion of returns than traditional investments. Therefore, diversification within a plan's alternative

investment portfolio is important in order to spread risk and reap the maximum benefit available. In this context, funds-of-funds are attractive and should be encouraged.

### *Significant Participation Test*

As you know, the Department's plan asset regulations describe situations where the assets and activities of a private investment fund will be subject to ERISA's rules. A fund that is said to "hold plan assets" must be operated in accordance with and subject to the limitations of ERISA's prohibited transaction restrictions. Under the current significant participant test, a fund holds "plan assets" if 25 percent or more of its equity interests are held by benefit plan investors.

As a general matter, managers of alternative asset funds will avoid becoming subject to ERISA, for good rather than bad reasons. ERISA's prohibited transaction restrictions can impose compliance and opportunity costs on other fund investors. One reason is that requirements under ERISA's prohibited transaction rules can make it more difficult to execute some strategies profitably, particularly certain hedge fund strategies. For example, to comply with administrative exemptions from ERISA's prohibited transaction rules, managers may have to take extra care in selecting counterparties and comply with additional conditions in trading. Use of leverage might also be limited. In the case of a fund of funds that holds plan assets, the fund's investment opportunities may become more limited because underlying fund managers may wish to avoid ERISA's requirements. Further, these funds' managers are already generally subject to restrictions under federal and state securities and other laws, in addition to contractual transparency and other requirements imposed by their institutional investors. The result is that the best alternative asset managers, who can afford to turn away investors because there is limited fund capacity, choose to turn away ERISA-covered plans to avoid the additional regulation applicable to managing

plan assets and the costs — including opportunity costs — associated with this additional regulation.

Section 611 of the Pension Protection Act of 2006 has amended the Department's plan assets regulation to improve the significant participation test, in two ways. First, the Act changed the definition of "benefit plan investor" so that it now only includes plans covered by ERISA and individual retirement accounts or other arrangements subject to section 4975 of the Internal Revenue Code. Until this change, non-ERISA plans such as governmental, church and foreign benefit plans also counted as benefit plan investors for purposes of the 25% threshold, often crowding out ERISA-covered plans.

The second change allows an entity that holds plan assets under the significant participation test to be counted as only holding plan assets to the extent of the percentage of the entity owned by benefit plan investors. This change will facilitate ERISA plan investments through "funds of funds" structures, because the funds of funds may have additional access to investment opportunities.

Section 611 of the Act did not change the 25% threshold under the significant participation test, although this change was proposed in earlier versions of the legislation. Unless changed, this 25% threshold will continue to impose unintended and arbitrary restrictions on plan investment opportunities. Retirement plans with the largest portfolios are most affected by this problem. For example, if a large sized plan and a smaller plan both devote the same percentage of the plan's portfolio to alternative investments, the absolute dollar amount of the investment by a large plan makes it harder for plan manager to access appropriate alternative asset investment opportunities. As an example, Prudential's defined benefit plan recently invested in a \$3 billion existing fund-of-funds vehicle. We were told that the plan's \$100 million investment, representing just 1% of the plan's assets and 3% of the fund vehicle, used up the fund-of-funds' entire "ERISA capacity."

*Increase the 25% Threshold to 50%*

Section 611 of the Act contemplates that the Department has promulgated regulations defining plan assets, and that the Department may amend its regulations to increase the 25% threshold. We encourage this working group to recommend to that the Department take the additional step of increasing the arbitrary 25% threshold to 50%. Such a change would improve opportunities for the largest ERISA plans to invest with the best alternative asset managers to obtain the diversification and other benefits of investing in alternative asset classes.

Thank you for your attention. I would be glad to answer your questions.

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Randy Hood is the senior investment manager responsible for the \$16 billion Domestic Employee Benefit Plans of Prudential Financial. He received a BA in Economics from Johns Hopkins University and an MBA in Finance and Accounting from the University of Chicago. He holds the Chartered Financial Analysts designation and is a reviewer for the Financial Analysts Journal. Randy has also served as a field artillery officer in the United States Army.