Hedging Bets on Employees' Futures: Is Investing Pension Fund Assets in Hedge Funds a Breach of Fiduciary Duty?

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HEDGING BETS ON EMPLOYEES' FUTURES:

IS INVESTING PENSION FUND ASSETS IN HEDGE FUNDS A BREACH OF FIDUCIARY DUTY?

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Introduction

Despite the fact that hedge funds remain an enigma to the majority of the country, more and more Americans are investing in them each year. Many of these new investments are direct investments in hedge funds made by wealthy investors who have enough assets to meet the minimum investment requirements set by funds.\(^1\) Increasingly, however, many others who do not meet these requirements are investing in funds nonetheless through various forms of indirect investments. Some of these indirect investments are made intentionally by investors who actively seek out the chance to participate in hedge funds, such as, for example, by investing in a fund of hedge funds.\(^2\) Of late, however, it has come to light that more and more Americans are becoming unwitting participants in hedge funds, most often as a result of their pension plan investing a portion of its assets in hedge funds.\(^3\)

\(^1\)See Alex R. McClean, Note, The Extraterritorial Implications of the SEC’s New Rule Change to Regulate Hedge Funds, 38 CASE W. RES. J. INT’L L. 105, 106 n.8 (2006) (citing Borla & Masetti, Hedge Funds: A Resource for Investors, 13 (2003)) (“The mean minimum investment required in the fourth quarter of 2000 was $630,729 while the median was $250,000.”).


There are currently two schools of thought on the propriety of investing pension plan assets in hedge funds. On the one hand, many support the idea, arguing that it serves to open the doors to the potentially lucrative world of hedge fund investment to many investors that are otherwise denied entry because their individual net worth does not meet the minimums necessary to be permitted to invest in hedge funds on their own. More importantly, proponents extol the virtues of hedge fund investment as a means for achieving diversity in pension fund portfolios. Since hedge fund performance is not tied directly to market performance, they laud hedge funds as a means of ensuring positive returns, regardless of how the stock market is performing. Opponents, on the other hand, worry that such investments by pension funds are exposing pension fund beneficiaries to risks that may be above and beyond their level of tolerance and, thereby, are breaches of fiduciary duty by pension fund managers.

The rule release also points out that as of 2002, approximately 20% of corporate and public pension plans in the United States had invested some portion of their assets in hedge funds, an increase over the 15% that had invested in hedge funds a year earlier. Id. at 58.

See id. at 108 (stating that hedge funds allow retirees investment opportunities they wouldn’t otherwise have); Veryan Allen, Hedge Funds and Pension Reform, http://hedgefund.blogspot.com/2006/08/pension-fund-and-401k-reform.html (last visited Jan. 17, 2008) (suggesting that hedge funds provide the most appropriate investment vehicle for individuals who are saving for retirement or who are already retired in that they are “the most reliable and consistent source of absolute investment returns” and lamenting the fact that hedge funds are not available to these individuals who need them most).


See Hedge Funds and Pension Reform, supra note 4 (claiming that a diversified portfolio including hedge fund investments is the only way to ensure “[r]eliable returns at low volatility and no negative years” for retirees).

See William Klunk, Pension Funds Investing in Hedge Funds, CONGRESSIONAL RESEARCH SERVICE (June 15, 2007) available at http://assets.opencrs.com/rpts/RS22679_20070615.pdf (warning that while hedge fund investors may benefit from high returns, they also risk losing their entire investment); David M. Katz, Lawmakers: Hedge-Fund Risk Hits Pension, http://www.cfo.com/printable/article.cfm/8844660/c_8913455?f=options (last visited January 17, 2008) (acknowledging the fact that “average investors [in hedge funds] have become increasingly exposed to serious personal financial loss”); Sargon Daniel, Note, Hedge Fund Registration: Yesterday’s Regulatory Schemes for Today’s Investment Vehicles, 2007 COLUM. BUS. L. REV. 247, 269 (2007) (describing the SEC’s concern over the retailization of hedge funds by saying that “the assets of these larger investors [e.g.,...
This paper explores the recent growth in hedge fund investments by pension funds and seeks to determine whether or not such investments are in the best interests of pension plan beneficiaries. Section I explains in detail what exactly a hedge fund is. The section defines hedge funds, as well as funds of hedge funds, and examines both the inherent risks of investing in hedge funds and the benefits derived from such investments. Section II explores the Employee Retirement Income Security Act ("ERISA"), the federal statute governing pension plans, in an effort to better understand the rules governing pension fund investments, as well as those laying out the fiduciary duties of the individuals who are in control of plan assets. Section III weighs the pros and cons of pension fund investments in hedge funds in an effort to determine whether such investments are a breach of fiduciary duty on the part of pension fund managers.

I. Hedge Funds

Alfred Winslow Jones is credited with creating the first hedge fund in 1949. He employed a strategy which consisted of using leverage in addition to going long on what he considered to be undervalued stocks, while short selling what he believed were overvalued stocks, in order to profit in both up and down markets. This strategy proved wildly successful when, in the decade spanning 1955-1965, Jones generated a 670% return, the highest return of any fund in the world. However, hedge funds have been in existence in practice since long before Jones first coined the term in the mid-twentieth century.

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8 See McClean, supra note 1, at 113 ("Alfred Jones created the first hedge fund in 1949.").
9 See id. (detailing the strategy utilized by Jones in his hedge funds).
10 See id. (stating that Jones’s 670% return was the highest in the world); see also Daniel, supra note 7, at 253 (noting that over that same decade, Jones outperformed mutual funds by 87%).
century. Investment banks have been going long and short on stocks since the 1920’s.\textsuperscript{11} However, Alfred Winslow Jones was the first to do so in a limited partnership form, thus creating the first modern hedge fund.\textsuperscript{12}

Despite the lengthy history of the hedge fund, it remains an investment vehicle understood by few, having eluded clear definition thus far.\textsuperscript{13} Even though so few people have a clear understanding of the way in which hedge funds work, an increasingly large segment of the population continues to invest in them, either through traditional hedge funds or indirectly through funds of hedge funds, both of which present decisive benefits and risks.

A. What is a Hedge Fund?


\textsuperscript{12}See id. (attributing to Jones’s creation the first hedge fund structured as a limited partnership).

\textsuperscript{13}See McClean, \textit{supra} note 1, at 108-09 (quoting SEC Chairman William Donaldson as saying he didn’t think the SEC would “ever come up with a definition that is broad enough or meaningful enough” to define a hedge fund). The closest the SEC has come to a definition thus far has been to state that the term [hedge fund] has no precise legal or universally accepted definition. The term generally identifies an entity that holds a pool of securities and perhaps other assets that does not register its securities offerings under the Securities Act and which is not registered as an investment company under the Investment Company Act.

At least one writer has defined the term as “legal entities that allow investors to pool their money together, which is then managed by an investment manager who exploits pricing inefficiencies in the market to generate high returns while trying to assume as little risk as possible.” \textit{Id} at 106. Academics define hedge funds as “privately offered, relatively unregulated pooled investment vehicles in the form of limited partnerships or limited liability companies that have the flexibility to invest in a broad range of securities and commodities using a broad range of trading techniques.” \textit{Id.} at 109. Yet another common definition states “[h]edge funds can generally be defined as entities that are exempt from registration as investment companies under the 1940 Act and whose interests, which are redeemable, are not sold publicly.” Jay Crenshaw, Note, \textit{Hedge Funds: Regulatory, Tax and Organizational Considerations}, 18 Fla. J. INT’L L. 359, 363 (2006).

\textsuperscript{14}Mcclean, \textit{supra} note 1, at 108.

\textsuperscript{15}See \textit{id.} at 9 (“[t]oday most hedge funds do not hedge in the traditional sense”).
Although, as noted above, hedge funds remain largely undefined, there are several defining characteristics shared by most, if not all, such funds. Common among hedge funds are fairly steep initial investment requirements, a limited number of investors, the ability of the fund to invest in a variety of financial instruments, the use of leverage and the charging of management and performance fees.

Perhaps the most common characteristic amongst hedge funds is their status as unregulated entities, the result of a series of exemptions from the securities laws of which

16 See id. ("[m]ost hedge funds today try to exploit temporary price discrepancies in the price of an underlying asset in world financial markets").
17 See id. at 109 (detailing the ways in which managers exploit mispriced securities, including the use of leverage).
18 See id. (describing the manner in which hedge funds use leverage to maximize gains while limiting losses).
19 See McClean, supra note 1, at 111 (describing the manner in which hedge funds “move independently of the stock market”).
20 See id. (noting the benefits to investors resulting from market neutrality). The author of this article goes on to describe the “low correlation coefficients” between hedge funds and the S&P 500:

A low correlation coefficient means that the two underlying securities, in this case hedge funds and the S&P 500, do not move in unison. This is important to investors because it allows them to earn positive returns regardless of how the stock market is performing. Investors who are looking to diversify their portfolios are looking for investment opportunities with low correlation coefficients because low correlation coefficients allow investors to eliminate the unsystematic risk in their portfolios.

Id. at 112.
21 See McClean, supra note 1, at 109.
22 See id. The number of investors is usually limited in an effort to escape registration of the fund under various securities laws. For example, in order to avoid having to register a fund under §12 of the Securities Exchange Act of 1934, a fund can have no more than 500 investors. See 15 U.S.C. §78l. Thus, most funds limit the number of investors in the fund to 499. See Daniel, supra note 7, at 260. A fund may avoid registration under the Investment Company Act provided its securities are owned by fewer than 100 investors. See 15 U.S.C. 80a-3(c)(1).
23 See McClean, supra note 1, at 109.
24 See Daniel, supra note 7, at 252.
25 See Daniel, supra note 7, at 252-53. Management fees charged by funds typically fall within the range of 1% to 2% of assets under management, while performance fees can be as high as 20% of the annual profits of the fund. See Amey Stone, Hedge Funds: Fees Down? Close Shop, BUSINESS WEEK, (Aug. 8, 2005), available at http://www.businessweek.com/bwdaily/dnflash/aug2005/mf2005088_1711_db042.htm (”Along with a 1% to 2% management fee levied on assets, hedge funds typically keep 20% of the profits generated each year as payment.”). Such high performance fees are justified by the claim that such a fee structure serves to align the interests of the fund manager with those of the investors. See id.
hedge funds are able to avail themselves. The ability of hedge funds to escape registration allows them to avoid many of the burdens with which mutual funds are faced, supplying them with their characteristic flexibility and making them “more nimble than their behemoth mutual fund siblings are for investing purposes.”

Among the burdens hedge funds are able to avoid are (1) the requirement of filing a registration statement, (2) the need to maintain books and records in the manner required by the Investment Advisors Act, (3) the mandate that they implement codes of ethics and compliance programs, (4) subjection to Securities and Exchange Commission (“SEC”) oversight and examinations and, perhaps most notably, (5) the requirement to obtain the approval of a majority of shareholders before making any changes to investment policy.

This is not to say that hedge funds function completely unchecked though. They are still subject to the anti-fraud provisions of the securities laws and are limited by the terms of the contracts that govern the fund, including the partnership agreements between the fund manager and its investors. More than anything else, however, hedge funds are increasingly becoming regulated by their institutional investors. Institutional investors, wielding great power due to the fact that they contribute more than half of hedge fund

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26 Hedge Funds are exempt from registering under the Securities Act of 1933 thanks to §4(2) which exempts from registration securities sold to sophisticated investors through nonpublic offerings. See 15 U.S.C 77(d)(2). Funds may avoid registration under the Investment Company Act of 1940 through the use of one of two exemptions. Section 3(c)(1) exempts funds with fewer than 100 clients within the United States and which do not make public offerings of their shares while §3(c)(7) exempts those that sell only to qualified purchasers (defined as any individual or family-owned company with more than $5 million in investments) and which also do not make public offerings. See 15 U.S.C. 80a-3(c)(1) and 3(c)(7). Hedge fund advisers can also escape registration under the Investment Advisers Act of 1940 if the fund maintains fewer than 15 clients.

27 Crenshaw, supra note 13, at 364.

28 See Registration Under the Advisers Act of Certain Hedge Fund Advisers, supra note 3, at 3.

29 See Daniel, supra note 7, at 264 (highlighting the ability of hedge funds to make decisions without requiring shareholder approval).

30 See Registration Under the Advisers Act of Certain Hedge Fund Advisers, supra note 3, at 3 (stressing that hedge funds “must nonetheless comply with the Act’s antifraud provisions”).
assets, have recently been placing more and more pressure on funds, demanding increased disclosure of trading positions, amounts of leverage and industry exposure, and requiring funds to provide quarterly, unaudited reports in addition to annual audited reports.\textsuperscript{31} Pressures placed on hedge funds by institutional investors have been leading more and more funds, which are otherwise exempt from registration, to register voluntarily in order to become more attractive investments to these large institutional investors. The results of a 2004 study conducted by the Hennessy Group LLC, a hedge fund advisory association, showed that

\begin{quote}
[d]ue to market forces predominantly driven by trust and ERISA fiduciaries, hedge funds are finding it necessary to become Registered Investment Advisers in order to attract capital from these sources. Thirty nine [percent] (39\%) of the hedge funds in our research were Registered Investment Advisers at the State or Federal (SEC) level. Ten percent (10\%) were registered with the NASD or CFTC. Nine [percent] (9\%) were registered with two or more regulatory agencies (i.e., SEC, NASD, CFTC).\textsuperscript{32}
\end{quote}

Thus, it appears that hedge funds may gradually be losing their unregulated nature - one of their most prized characteristics - as institutional investors place greater demands on funds in exchange for the privilege of managing their sizable assets.\textsuperscript{33}

\section*{B. Funds of Hedge Funds}

Although funds of hedge funds would not exist in the absence of hedge funds, funds of hedge funds are both better understood and less feared entities than their enigmatic cousin the hedge fund. They are also more clearly defined than hedge funds.

\textsuperscript{31}See McClean, supra note 1, at 122, 134 (enumerating the multitude of demands institutional investors are placing on hedge funds).

\textsuperscript{32}See Gradante, supra note 11, at 10-11.

\textsuperscript{33}See McClean, supra note 1, at 134 (pointing out that in many instances, institutional investors are demanding more information than regulators are).
A fund of hedge funds can be precisely defined as an investment company that pools the assets of its investors (much like a hedge fund) and invests that pool of assets in other funds, rather than in individual securities (unlike a hedge fund which invests directly in securities).\textsuperscript{34} In a speech before the ABA Section of Business Law, Commissioner Atkins of the SEC defined funds of hedge funds as “registered mutual funds whose underlying investments consist of hedge funds.”\textsuperscript{35} Thus, unlike most hedge funds, many funds of hedge funds register their securities with the SEC.\textsuperscript{36}

While many funds of hedge funds offer shares only to institutional investors, there is nothing in the securities laws preventing them from making public offerings of their shares, provided they register their shares with the SEC before making any such public offering.\textsuperscript{37} Funds of hedge funds, much like the hedge funds underlying them, have investment requirements, with most requiring a minimum initial investment of at least $25,000\textsuperscript{38} and limiting investment opportunities to those individual who qualify as accredited investors.\textsuperscript{39} These limits are not statutory, but rather are self-imposed by the funds of hedge funds.\textsuperscript{40} Recent speculation suggests that funds of hedge funds may

\textsuperscript{34}See Hedging Your Bets, supra note 2, at 1 (defining a fund of hedge funds as “an investment company that invests in hedge funds – rather than investing in individual securities”).
\textsuperscript{35}Paul S. Atkins, Commissioner, U.S. Securities and Exchange Comm’n, Remarks Before the ABA Section of Business Law - 5th Annual Conference on Private Investment Funds (March 2, 2004).
\textsuperscript{36}See id. (noting that the funds of hedge funds that do register must, once registered, supply their investors with prospectuses and file quarterly reports with the SEC). Many of the funds of hedge funds that have chosen to voluntarily register have explained their reason for doing so as an acknowledgement of the fact that “for all intents and purposes, their activities are no different from a traditional mutual fund,” which is required to register with the SEC under the Investment Company Act of 1940. See The Fund of Hedge Funds Industry Report, supra note 2.
\textsuperscript{37}See supra note 46 (demonstrating that just over half of the registered funds of hedge funds in existence in 2003 offered shares publicly).
\textsuperscript{38}See William H. Donaldson, Chairman, U.S. Securities and Exchange Comm’n, Testimony Concerning Investor Protection and the Regulation of Hedge Funds Advisers (contrasting this sum to the million dollar minimums required by hedge funds).
\textsuperscript{39}See id. (defining accredited investors as those with income exceeding $200,000 for the past two years or having a net worth of at least $1 million).
\textsuperscript{40}See id. (noting that there are no federal requirements in existence for the setting of minimum investment thresholds).
choose to lower these limits in an effort to make themselves more accessible to a larger number of investors.\textsuperscript{41}

That is not to suggest that funds of hedge funds have suffered from a dearth of investors. The fund of hedge fund industry, like the hedge fund industry itself, has virtually exploded with new growth over the past decades.\textsuperscript{42} The burgeoning of this industry seems closely tied to the ever increasing interest in hedge funds in general, being largely attributed to two sources: (1) the increased interest of institutional investors in hedge funds\textsuperscript{43} and (2) the rising interest of the general public in hedge funds.\textsuperscript{44} The rapid expansion of the industry is attested to by the ever-increasing number of funds of hedge funds registering with the SEC. In 2003, there were approximately 82 registered funds of hedge funds.\textsuperscript{45} By 2005, the number of registered funds had surpassed 100.\textsuperscript{46} These numbers exclude the undoubtedly large number of funds of hedge funds that are in existence but are not registered with the SEC.\textsuperscript{47} Providing 25% of the capital contributions to hedge funds,\textsuperscript{48} funds of hedge funds have been touted as “the fastest growing source of capital for hedge funds.”\textsuperscript{49}

\begin{itemize}
\item \textsuperscript{41}See id.
\item \textsuperscript{42}See The Fund of Hedge Funds Industry Report, supra note 2 (citing the industry as controlling $81 billion in assets as of 2003). The SEC put forth a significantly more conservative estimate, suggesting there was $3.7 in assets under management in 2003. See Atkins, supra note 35.
\item \textsuperscript{43}See The Fund of Hedge Funds Industry Report, supra note 2 (noting the rise in both the number of institutional investors who are investing and in the amount of assets being invested).
\item \textsuperscript{44}See id. (explaining that the rise in interest “has led traditional asset managers to offer hedge fund products, and hedge fund managers to partner with traditional financial distribution channels to access individual assets”).
\item \textsuperscript{45}See Atkins, supra note 35.
\item \textsuperscript{46}See Registration Under the Advisers Act of Certain Hedge Fund Advisers, supra note 3, at 5 n.35 (indicating that of these 103 registered funds, 52 sold or planned to sell their shares publicly while the remaining 51 sold shares solely through private offerings). There is no data on the number of unregistered funds of hedge funds. Id.
\item \textsuperscript{47}See id. (admitting that the SEC has no data on the number of unregistered funds of hedge funds in existence).
\item \textsuperscript{48}See Atkins, supra note 35.
\item \textsuperscript{49}Id.
\end{itemize}
C. Benefits Derived from Hedge Funds and Funds of Funds

Both hedge funds and funds of hedge funds offer investors unique benefits not found in direct investments in equities or in investments in mutual funds. Primarily, they offer investors the promise of greater returns than mutual funds or equities alone may be able to offer. This is due to a combination of features present in hedge funds and funds of hedge funds, which are lacking in equities or mutual funds. Among these features are (1) the use of leverage to bring about even greater returns than would be gotten without borrowing additional funds to invest; (2) the ability to move more quickly than mutual funds when making investment decisions due to the fact that hedge funds do not need shareholder approval to make changes to investment objectives; (3) the ability to engage in riskier investment strategies than regulated mutual funds; and (4) the ability to invest in a wider variety of instruments than mutual funds. Hedge funds and funds of hedge funds also offer the benefits of professional management of investor assets, making them an arguably better investment choice than direct investments in individual equities.

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50 See supra note 10 (stating that Alfred Winslow Jones’ hedge funds outperformed mutual funds by 87% over the course of a decade).
51 See supra note 18 and accompanying text.
52 See supra note 27 and accompanying text.
54 See McClean, supra note 1, at 109 (citing the ability of hedge funds to invest in a “broad range of securities and commodities using a broad range of trading techniques”).
55 See id. (including in the definition of hedge funds the fact that they are managed by investment managers).
Another major benefit of investing in hedge funds or funds of hedge funds - perhaps equal in importance to the chance of earning higher returns - is that of market neutrality. As discussed above, hedge fund performance is not tied to the success of the markets.⁵⁶ Thus, hedge fund investors have the opportunity to experience positive returns even during periods of weak performing - or even failing - markets, making hedge funds and funds of hedge funds valuable diversification tools in ensuring a steady return on investments.⁵⁷

There are also a series of benefits offered specifically by funds of hedge funds. For one thing, funds of hedge funds offer greater diversification than do investments in a single hedge fund, thus spreading risk across several hedge funds rather than concentrating it in any one hedge fund.⁵⁸ Funds of hedge funds also tend to register their securities with the SEC more often than do individual hedge funds.⁵⁹ This leads many investors to view investments in funds of hedge funds as safer than investments in hedge funds directly. It also creates more transparency in funds of hedge funds than exists in hedge funds, since registered funds are required to provide prospectuses to their investors and must file reports with the SEC on a quarterly basis.⁶⁰ Finally, funds of hedge funds make hedge fund investment more broadly available to the public, allowing investors who may not otherwise be able to meet the minimum investment requirements of hedge funds.

⁵⁶ See supra note 19 and accompanying text.
⁵⁷ See supra note 20 and accompanying text.
⁵⁸ See Greg Gregoriou, Funds of Hedge Funds, ELSEVIER, http://www.elsevier.eu/wps/find/bookdescription.cws_home/708379/description#description (last visited April 2, 2008) (“A Fund of Hedge Funds (FOF) spreads investments among a number of hedge funds to reduce risk and provide diversification, while maintaining the potential for higher than average returns.”).
⁵⁹ See supra note 36 and accompanying text.
⁶⁰ See id.
funds the ability to invest in hedge funds nonetheless through a back door of sorts.\textsuperscript{61} However, this last feature of funds of hedge funds is not viewed by all as an advantage. As discussed below, many critics see this as a negative impact of funds of hedge funds.

\textbf{D. Inherent Risks of Hedge Funds and Funds of Funds}

For all of the benefits offered by hedge funds, there also exists a fair share of pitfalls brought about by these investment vehicles. Perhaps the biggest complaint against hedge funds is the lack of governmental oversight under which they operate. As discussed above, hedge funds function as largely unregulated entities.\textsuperscript{62} As hedge funds become more popular and more widely available to investors, calls for the increased regulation of the funds grow louder, as proponents stress the need for increased protection of investors.\textsuperscript{63} Of greatest concern to those clamoring for increased regulation is the protection of so-called “unsuspecting retail investors,” those whose assets are swept into hedge fund investments without their explicit knowledge, either through investments in funds of hedge funds or participation in employer sponsored pension plans which invest in hedge funds.\textsuperscript{64} In response to such cries, former SEC Commissioner Paul Atkins made clear that the SEC staff found no proof of such retailization actually occurring.\textsuperscript{65}

\textsuperscript{61}See Registration Under the Advisers Act of Certain Hedge Fund Advisers, \textit{supra} note 3, at 5 (crediting funds of hedge funds with making hedge funds “more broadly available” to investors).

\textsuperscript{62}See \textit{supra} note 26 and accompanying text.

\textsuperscript{63}See Paul S. Atkins, Commissioner, U.S. Securities and Exchange Comm'n, Open Meeting to Consider the Registration of Hedge Fund Advisers (Oct. 26, 2004).

\textsuperscript{64}See \textit{id.} (reporting that “proponents of registration raise cries of ‘retailization.’ They say that hedge funds are surreptitiously reaching into the pockets of suspecting retail investors, including investors in funds of hedge funds and vulnerable retirees.”).

\textsuperscript{65}See \textit{id.} at 2 (specifying that the 2003 Staff Hedge Fund Report uncovered no proof of retailization); \textit{see also} Gradante, \textit{supra} note 11, at 8 (finding as another reason for the lack of retailization the fact the most hedge funds don’t want retail customers as clients).
Even if no mass retailization of hedge funds is, in fact, occurring, the sheer volume of capital that is invested in hedge funds cannot be denied. A report compiled by the SEC staff in 2003 revealed roughly $600-650 billion in assets invested in hedge funds. Many harbor very real fears that should unregulated hedge funds run amok in the markets, millions of Americans risk losing their life savings, as well as their pensions, requiring a tax payer bailout that could run into the billions of dollars.

On the other side of the argument are those who point out that the majority of the investors in hedge funds are still institutional investors and “sophisticated” investors - both being groups that can fend for themselves in the world of investments. Chairman of the Federal Reserve Ben Bernanke made clear his view on the matter stating

In the case of hedge funds, securities laws effectively allow only institutions and high-wealth individuals to invest in them. These investors generally have the resources and sophistication, as well as the incentive, to monitor the activities of the hedge funds. Large investors are not only well equipped to assess the management, strategies, performance, risk-management practices, and fee structures of individual hedge funds but they also have the clout to demand the information they need to make their evaluations.

Coming in a close second among the complaints against hedge funds is their lack of transparency. Barton Biggs, founder of the hedge fund Traxis Partners, has come out of late as one of the most vocal proponents of increased regulation of hedge funds. Biggs cites the lack of transparency in the industry as one of the reasons more regulation is needed, readily admitting that the hedge fund industry is “one of the most secretive”

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66See Atkins, supra note 35 (comparing that amount to the $6.5 trillion invested in mutual funds and the $11.8 trillion invested in corporate equities).
67See Klunk, supra note 7, at 5 (noting that “shortfalls in public pensions are borne by taxpayers in those jurisdictions”); Katz, supra note 7 (warning that “if pension beneficiaries lose their retirement money . . . taxpayers could be forced to pay for their social services”).
68Hedge Fund Regulation, supra note 53.
69See Zarolli, supra note 53 (giving an interview on NPR’s Morning Edition to voice his opinions on the matter).
and noting that “[a]s a rule, hedge fund managers don’t talk to the press much.”

Many managers claim the lack of transparency is the result of efforts to keep trading strategies and other trade secrets out of the hands of competing funds, but investors often fear it is nothing more than a cloak used to conceal fraud and other illicit activities on the part of fund managers.

In addition to these drawbacks of hedge funds, there are added complaints focusing specifically on funds of hedge funds. Perhaps the most common criticism of funds of hedge funds is their practice of “fee layering.” Fee layering occurs when a fund of hedge funds charges investors a set of fees for investing in the fund of hedge funds and then also passes along to investors the fees charged by the underlying hedge funds in which the fund of hedge funds invests. Thus, investors are, in essence, paying two layers of fees for each investment they make in a fund of hedge funds.

Funds of hedge funds are also routinely criticized for allowing investors who are otherwise denied entry into hedge funds the chance to invest in hedge funds.

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70 Id. Among Biggs’ other reasons for supporting increased regulation are the gross overpopulation of the industry which he describes as a “losers game with too many funds chasing too few profits.” Id. He also points to the “long slumps and spectacular flameouts” the industry has suffered through. Id.

71 See Paul F. Roye, Director, Division of Investment Management, U.S. Securities and Exchange Comm’n, Keynote Address on the Risks and Opportunity for Public Pension Plans (July 17,2001) (noting that hedge fund managers are able to profit when they possess information to which other managers aren’t privy).

72 See, e.g., Special Report- Hedge Fund Questions and Answers, HIG, http://www.hewittinvest.com/DBenefit/db_specialreport_hedgefundqa.cfm (last visited April 2, 2008) (warning readers that “due to lack of transparency and regulation there is a risk of fraud within the hedge fund sector”).

73 See Hedging Your Bets, supra note 2, at 2 (warning investors that when investing in a fund of hedge funds, they “will pay two layers of fees: the fees of the fund of hedge funds and the fees charged by the underlying hedge funds”).

74 See Chris O’Leary, The High Cost of Administration, NEW YORK UNIVERSITY STERN SCHOOL OF BUSINESS, http://w4.stern.nyu.edu/news/news.cfm?doc_id=4160 (last visited April 2, 2008) (informing listeners that “[a]s long as the funds of funds can either provide access, diversification or add value, then the fees are justified but . . . if a fund of fund is so overdiversified that its program resembles an index fund or simply turns to mush, that extra layer of fees is going to be hard to justify”).
nonetheless. While many praise funds of hedge funds for this exact reason, critics speak out against the practice, claiming that these funds of hedge funds, by allowing investors who are not permitted to invest in hedge funds directly to do so indirectly, are exposing such investors to risks they may be unable to bear. After all, they argue, aren’t these investors barred from investing directly in hedge funds for a reason?

II. The Investment of Pension Funds Under ERISA

Putting aside the topic of hedge funds momentarily, this paper will now turn to the laws governing pension plans, namely ERISA.

A. Regulation of Pension Funds

By the mid-1970's, the need for greater regulation of pension funds had become obvious. Funds of that era faced many serious problems, the biggest being insufficient funding and reserves among plans. More and more Americans were finding themselves without a source of retirement income after the companies for which they worked went out of business or simply ended their pension plans. In 1974, ERISA was passed in an

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75 See Atkins, supra note 53, at 2 (noting the concern raised by the fact that funds of hedge funds open the doors to hedge fund investing to more investors).
76 See Donaldson, supra note 38, at 3 (voicing concern over the fact that funds of hedge funds allow investors indirect access to hedge funds in which they are not permitted to invest directly).
78 See Regulatory Implications of Individual Management of Pension Fund: The Challenge to Financial Regulators Posed by Social Security Privatization, 64 BROOKLYN L. REV. 1043, 1070 (1998) [hereinafter Regulatory Implications] (remarking that prior to the 1970's, pension funds were overseen by the Internal Revenue Service “if at all”).
79 See id. (citing lack of funding as an endemic problem among pension funds). This problem still exists today. See Craig C. Martin and Joshua Rafsky, The Pension Protection Act of 2006: An Overview of Sweeping Changes in the Law Governing Retirement Plans, 40 J. MARSHALL L. REV. 843, 850 (2007). A study conducted by the Government Accountability Office found that from 1995 to 2002, over one-third of the 100 largest defined benefit plans were underfunded, with one-quarter of them being less than 90% funded. Id. Such plans included those of Delta, US Air, United Airlines, Polaroid, Kaiser Aluminum and Bethlehem Steel. Id.
80 See Regulatory Implications, supra note 78, at 1070 (discussing how, as a result of such occurrences, “the pension benefits of many workers were impaired”).
attempt to alleviate these problems. It was aimed at increasing funding requirements and raising levels of fiduciary responsibility.\textsuperscript{81} At the same time, it also established the Pension Benefit Guaranty Corporation, an organization created to assist employees who had vested benefits in plans which terminated before such benefits were paid out to them.\textsuperscript{82}

Even after the passage of ERISA, however, regulation of pension funds is still far from flawless.\textsuperscript{83} Current oversight of pension funds takes the form of a concerted effort among the Pension Benefit Guaranty Corporation, the Department of Labor, the Internal Revenue Service and the states.\textsuperscript{84} Simultaneous oversight by so many government entities would lead many to believe that pension funds were among the most heavily regulated, and therefore safest, forms of investment in existence. Unfortunately, quite the opposite proves true. Each entity mentioned above has widely varied interests, which leads to piecemeal regulation and opens up the possibility of many problems falling through the cracks unsolved.\textsuperscript{85}

To begin with, the enforcement powers of the Pension Benefit Guaranty Corporation are weak at best. It lacks corrective authority, meaning it cannot force a plan to change practices that it may deem inappropriate, and may only seek court approval for

\textsuperscript{81}See id. at 1070-71 (listing the threefold accomplishments of ERISA as its having "strengthened funding and fiduciary discipline and established the Pension Benefit Guaranty Corporation").

\textsuperscript{82}See id. at 1071 (describing the purpose of the Pension Benefit Guaranty Corporation as "ensure[ing] that vested benefits would survive plan terminations"). The Pension Benefit Guaranty Corporation insures vested pension benefits up to a certain monthly limit in case of plan termination. \textit{Id.} However, this insurance applies only to defined benefit plans and not defined contribution plans. \textit{Id.}

\textsuperscript{83}See Roberta S. Karmel, \textit{The SEC at 70: Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility - What Regulation by the Securities and Exchange Commission is Appropriate?}, 80 Notre Dame L. Rev. 909, 912 (2005) [hereinafter \textit{The SEC at 70}] (noting that the regulation of pension funds, hedge funds and "other collective investment pools" is beyond the purview of the SEC).

\textsuperscript{84}See id. ("[p]ension funds are regulated by the Pension Benefit Guaranty Corporation, the Department of Labor and the states").

\textsuperscript{85}See id. (describing regulation by so many governmental bodies at once as "neither consistent nor coherent").
the termination of a plan if the plan is underfunded.\(^{86}\) It must share its powers in monitoring the fiscal health of plans with the Internal Revenue Service.\(^{87}\) It also has no power to bring suit for breach of fiduciary duty by plan trustees;\(^{88}\) only the Department of Labor may bring those suits.\(^{89}\) Despite the fact that state law usually governs cases involving breach of fiduciary duty, ERISA trumps all such state law claims, with the result that state law plays no part in the regulation of investments or capital funding of pension plans.\(^{90}\) So one can easily see the quagmire created by so many layers of regulation.

**B. ERISA Fiduciaries**

Still, ERISA was a step in the right direction. It has done much to set at least minimum standards under which pension funds and their trustees must operate. Perhaps the most important change brought about by ERISA was the imposition of fiduciary duties upon all who exercise control over plan assets, requiring "fiduciary responsibility for all investment managers, trustees and any other person with control over a pension plan or its assets."\(^{91}\) Again, however, no one regulator oversees managers of private pension funds.\(^{92}\) Because managers of these funds can take several forms, including

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\(^{86}\) See id. at 920-21 (discussing the limited circumstances under which the Pension Benefit Guaranty Corporation can request termination of a plan).

\(^{87}\) See id. at 920 (pointing out that the Pension Benefit Guaranty Corporation's "[r]esponsibility for monitoring the financial soundness of pensions is split with the Internal Revenue Service").

\(^{88}\) See Karmel, supra note 83, at 920-21 (noting that fiduciary duty suits must be brought by the Department of Labor).

\(^{89}\) See id.

\(^{90}\) See id. at 921 (making clear that "ERISA broadly preempts state law breach of fiduciary duty actions").

\(^{91}\) Regulatory Implications, supra note 78, at 1071; see also Crenshaw, supra note 13, at 388 (stating that ERISA "imputes certain fiduciary duties upon persons that advise, for a fee, or exercise discretionary authority or control over certain employee benefit plans").

\(^{92}\) See Regulatory Implications at 1071 (noting that managers are not regulated by one specific regulator).
insurance companies, banks, broker-dealers and mutual funds, they are regulated by a myriad of entities.\textsuperscript{93}

1. Who is an ERISA Fiduciary?

One group exempt from being deemed ERISA fiduciaries are registered investment companies.\textsuperscript{94} Hedge funds, however, cannot benefit from this exemption because they are not registered investment companies.\textsuperscript{95} Thus, if hedge fund managers exercise any discretion over ERISA plan assets, they automatically become subject to ERISA fiduciary standards.\textsuperscript{96} It is important, therefore, to determine when a hedge fund manager is deemed to have discretion over plan assets.\textsuperscript{97}

The first step in determining whether a hedge fund manager is subject to ERISA's fiduciary duties is to determine whether he or she has control of plan assets:

When a plan acquires the securities of an invested entity [such as a hedge fund] that is not publicly offered nor registered under the 1940 Act, plan assets will be deemed to also include an undivided interest in each of the underlying asset of the invested entity. As a result, a person exercising discretion over such invested entity's assets (e.g., hedge fund advisers), which are now considered to be plan assets under ERISA's attribution provisions, will, under certain circumstances, also be imputed ERISA fiduciary duties.\textsuperscript{98}

There are two exceptions though, which may allow a hedge fund manager to escape ERISA fiduciary responsibility despite the fact that the manager may be in control of plan assets. The first excepts operating companies from ERISA's attribution provisions and

\textsuperscript{93}See id. (explaining that insurance companies are under the purview of state insurance commissioners, while banks are governed by federal and state banking laws). The author goes on to note that when broker-dealers or mutual funds manage pensions, there are no guidelines for investments. Id.

\textsuperscript{94}See Crenshaw, supra note 13, at 388-89 (noting the specific exemption of registered investment companies from being deemed ERISA fiduciaries).

\textsuperscript{95}See supra note 26 (describing the un-registered nature of hedge funds).

\textsuperscript{96}See Crenshaw, supra note 13, at 389 (explaining that hedge fund managers become subject to ERISA once they have discretion over plan assets).

\textsuperscript{97}See id. (describing the determination of whether hedge fund managers have control over plan assets as "pivotal" in discerning whether those managers are subject to ERISA).

\textsuperscript{98}Id. at 390.
thus does not apply to hedge funds since hedge funds are not operating companies.\textsuperscript{99} The second proves more useful to hedge funds, allowing an invested entity (e.g., a hedge fund) to be excluded from the attribution rules if the investments in the entity by pension funds are not "significant."\textsuperscript{100} A "significant" investment is considered to exist any time a pension plan holds "25% or more of the value of any class of equity interests in an invested entity."\textsuperscript{101} In order to reap the benefits of this second exception, most hedge funds limit pension plan investments in them to a maximum of 24.99%.\textsuperscript{102} However, some hedge funds do permit pension plan investments of more than 25%, preferring to

\textsuperscript{99}See id. (defining operating companies as invested entities that are "(1) primarily engaged in the production or sale of products or services - other than the investment of capital; and (2) venture capital operating companies").

\textsuperscript{100}See id. at 391 (lamenting this second exception, upon which hedge funds rely, as "less favorable"); see also Pension Protection Act of 2006 - Plan Assets and Prohibited Transaction Matters, (Aug. 8, 2006), available at http://www.simpsonthacher.com/content/publications/pub562.pdf (explaining to clients that When a plan subject to Title I of ERISA or Section 4975 of the Internal Revenue Code (each, an “ERISA Plan”) acquires an equity interest in an entity (an “Investment Fund”) that is neither a “publicly-offered security” nor a security issued by an investment company registered under the Investment Company Act of 1940, the ERISA Plan’s assets will be deemed to include not only the equity interest itself, but also an undivided interest in each of the underlying assets of the Investment Fund, unless the Investment Fund either operates as a VCOC or an REOC, or the Investment Fund at all times satisfies the 25% Test. For purposes of the 25% Test, the assets of an Investment Fund would not be considered “plan assets” and the sponsor would not be subject to the fiduciary responsibility or prohibited transaction rules of ERISA or the Internal Revenue Code if, at all times, less than25% of the value of each class of equity interests of the Investment Fund are held by “benefit plan investors.”) Note also that the 25% investment needed to make a hedge fund manager an ERISA fiduciary does not need to be invested in a hedge fund by one single pension fund. See Chaim J. Fortgang and Thomas Moers Mayer, Developments in Trading Claims: Participations and Disputed Claims, 15 CARDOZO L. REV. 733, 742 (1993). If several pension funds invest in a hedge fund and their cumulative investments in any equity class of the fund equal or exceed 25%, the hedge fund manager will be deemed an ERISA fiduciary. \textit{Id.}

\textsuperscript{101}Crenshaw, supra note 13, at 391. Only ERISA plans count towards this 25% limit. \textit{Id.} Thus, government, church plans, and non-US plans do not apply towards the 25%. \textit{Id.} This change (among others) was brought about in August 2006 with the passage of Pension Protection Act. Prior to this, investments by such plans were counted towards the 25% threshold.

\textsuperscript{102}See id. (commenting on the practice among hedge fund managers of limiting pension fund investments to "24.99% of any class of its equity interests").
cope with the consequences of being deemed to have discretion over plan assets to forfeiting the large amounts of money brought in by pension funds.103

2. What Fiduciary Duties Does ERISA Impose?

The two main fiduciary requirements set out by ERISA are the duty to avoid engaging in prohibited transactions between ERISA plans and interested parties and the duty to diversify investments, both of which fall under the duty of care.104 Only the latter will be discussed in this paper.

Defined benefit plans,105 specifically, are prohibited from investing all or even substantially all of their assets in any one security or group of securities which are tied to the performance of a single industry or area.106 This requirement is not based on a set percentage of assets, but rather is more loosely governed by the prudent investor standard.107 The diversification requirements for pension fund investments will be explored in greater detail below in Section III.

C. Recent Trends in Pension Fund Investment

103 See Alison S. Fraser, Note, The SEC's Ineffective Move Toward Greater Regulation of Offshore Hedge Funds: The Failure of the Hedge Fund Registration Requirement, 92 CORNELL L. REV. 795, 820 (2007) (noting the willingness of some hedge fund advisers to accept the responsibility of being an ERISA fiduciary because of the amount of money brought in by pension funds).
104 See Crenshaw, supra note 13, at 388 (detailing the elements of the ERISA duty of care).
105 In a defined benefit plan, beneficiaries are promised a set monthly payout upon retirement. See Defined Benefit and Contribution Pension Plans, http://retireplan.about.com/cs/retirement/a/aa_defined_a5.htm (last visited April 2, 2008). It is the responsibility of the employer to contribute enough to the plan and invest those contributions wisely enough to make this monthly payout feasible. Id. In a defined contribution plan, an employer promises to contribute a set amount to the plan for each beneficiary each month. Id. The beneficiary must then manage the investment of those contributions. Id. The employer makes no promises as to what amount will be paid out upon retirement. Id. That amount depends upon the success of the investments made by the beneficiary. Id.
106 See Karmel, supra note 83, at 919 (“This diversification requirement prohibits a fiduciary from investing the whole or an unreasonably large proportion of the trust assets in either one type of security or a group of securities that are all dependent on the welfare of one industry or the conditions in one geographical area.”).
107 See Restatement of the Law Third, Trusts: Prudent Investor Rule §227 (1992) (defining the prudent investor standard as follows: “The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust.”).
In the late 1940's, one-third of pension plan assets were invested in annuities issued by insurance companies and backed by long-term, mostly government issued, bonds.\textsuperscript{108} The vast majority of the remaining two-thirds was invested in bonds as well, leaving only a meager portion of pension assets to be invested in equities.\textsuperscript{109} It was not until the emergence of modern portfolio theory that pension funds began their gradual move away from the stoic safety of bonds toward the riskier, but more rewarding, world of equity investment.\textsuperscript{110} Preaching the long-term benefits of investment in equities rather than bonds and the necessity of diversification, modern portfolio theory completely revamped the investment strategies of institutional investors.\textsuperscript{111} This, coupled with inflation - which led to lower returns on bonds - and rising salaries - which resulted in higher required payouts to pension beneficiaries, - spurred pension funds to begin their on-going quest for "more speculative ventures."\textsuperscript{112} More and more often in recent years, that quest has led pension fund managers to turn to hedge funds.

III. Is Investing in Hedge Funds a Breach of Fiduciary Duty on the Part of Pension Fund Fiduciaries?

A. Pros of Pension Fund Investment in Hedge Funds

\textsuperscript{108}See The SEC at 70, supra note 83, at 924.
\textsuperscript{109}See id. (specifying that more than 80\% of the remaining two-thirds was invested in bonds, with only 5\%, at the most, being invested in corporate equities).
\textsuperscript{110}See id. at 924 n.83 (defining modern portfolio theory as an investment strategy aimed at achieving a specified level of return at the minimum investment risk. Portfolio managers utilizing MPT diversify their portfolios according to the MPT risk/return model. The investment portfolio is evaluated on the basis of its overall performance instead of performance of particular stocks. Two main factors in MPT are expected return and standard deviation return. Assets with various rates of return and standard deviations are selected by a fiduciary to achieve an expected return and reduce standard deviations. MPT is a basis for the Uniform Prudent Investor Act.)
\textsuperscript{111}See id. at 924 (remarking that MPT "persuaded many investors to heavily weight their portfolios in equities").
\textsuperscript{112}Id. at 925. By the close of 2003, state pension funds were allocating an average of 65\% of their assets to equities, leaving only 35\% invested in fixed-income securities. Id. Included in the 65\% are private equity investments. Id.
Issues surrounding pensions and pension plan investments are becoming of increasingly crucial concern to Americans as millions of baby boomers\textsuperscript{113} stand poised to retire.\textsuperscript{114} Such mass-retirement by American workers is straining the abilities of pension funds to produce large enough payouts to cover such a vast number of new retirees at virtually the same time.\textsuperscript{115} In an effort to ease their struggle, pension funds have begun seeking new forms of investments offering higher - and steadier - returns than traditional equity and bond markets. One such investment being turned to with increasing frequency is the hedge fund.

Among the responsibilities with which pension fund managers are faced is the job of matching the growth of pension fund assets with pension fund liabilities in order to ensure there will be an adequate source out of which to pay benefits due to plan participants.\textsuperscript{116} Many suggest that investments in hedge funds is the best way to achieve this balance, as they often bring in higher and steadier rates of return than traditional investment vehicles.\textsuperscript{117} Many European pension funds found this to be true when, in the

\textsuperscript{113}\textit{See} Martin & Rafsky, \textit{supra} note 79, at 844 (defining "baby boomers" as "the segment of our population that is the result of [the population explosion following the return home of soldiers from World War II] - those born after World War II from 1946 to 1964"). Baby boomers are estimated to comprise 16\% of the US population. \textit{Id.}

\textsuperscript{114}\textit{See id.} at 843 (reporting that pension issues become "of paramount importance" as baby boomers near retirement age).

\textsuperscript{115}\textit{See id.} at 844-45 (noting that "the retirement of such a large segment of the population challenges the ability of . . . benefit programs to provide sufficient resources for our aging workforce"); \textit{see also} Tomoe Murakami Tse, \textit{Public Pension Systems Betting on Hedge Funds}, WASHINGTON POST, July 24, 2007, at D01 (reporting that the Massachusetts pension system has only "slightly beaten" its 8\% required return over the last 12 years and noting that the equities market is not predicted to keep up that level of return).

\textsuperscript{116}\textit{See Veryan Allen, Pension Funds Need Hedge Funds}, http://hedgefund.blogspot.com/2006/05/prudent-pensions-need-hedge-funds.html (last visited Nov. 13, 2007) (describing the job of pension plan sponsors as that of matching liabilities with asset growth).

\textsuperscript{117}\textit{See id.} (citing hedge funds as the safest way to do just that); Melanie Waddell, \textit{A Boon for Hedge Funds?}, (Oct. 1, 2006), available at http://www.investmentadvisor.com/print.php?printscreen=yes&topic=&article=9839 (noting that many defined benefit plans are turning to hedge funds for assistance in meeting their benefit obligations).
wake of major losses suffered during the dot.com bust in 2000, they turned to hedge funds in an effort to combat their increasing liabilities.\(^{118}\)

Perhaps the reason that hedge funds have proved so useful a tool to pension fund managers in their efforts to keep pace with ever-increasing pension fund liabilities is the fact that hedge funds are better suited to today's fluctuating markets than are investments in traditional equities and bonds.\(^{119}\) While the stock market of the 1980's proved quite successful, some claim that that success was not the norm.\(^{120}\) They point out that while that market was able to produce returns sufficient enough to support the retirees of the day, the same cannot be said of the current market.\(^{121}\) Today's retirees need steady returns and can no longer tolerate volatility and years of loss.\(^{122}\) A diversified portfolio of hedge funds, they claim, is the only course of action guaranteed to meet their needs.\(^{123}\)

Hedge funds also provide pension fund managers with a much needed tool for diversification. Pension fund managers are coming to see a shift away from stocks and towards "modest hedge fund holdings" as "reasonable since hedge funds offer returns not linked to stock market performance."\(^{124}\) Such sentiments are not unique to U.S. pension


\(^{119}\)See Pension Funds Need Hedge Funds, supra note 116 (claiming that hedge funds, particularly those with long volatility strategies, are best-suited for fluctuating markets); see also Hedge Funds and Pension Reform, supra note 4 (remarking that equities have become too dangerous while bonds do not create enough capital).

\(^{120}\)See Hedge Funds and Pension Reform, supra note 4 (describing the markets of the 1980's as "atypical").

\(^{121}\)See id. (pointing out that while the returns produced by the 1980's stock market were "good enough for retirees then," the returns produced by the current market are not sufficient to support today's retirees).

\(^{122}\)See id. (laying out the needs of today's retirees as "[1] reliable returns at low volatility and [2] no negative years").

\(^{123}\)See id. ("only a diversified portfolio of hedge funds can guarantee that"); Tse, supra note 115 (quoting the executive director of the Fairfax County, Virginia pension fund as saying "It's about developing a smoother return stream and managing the level of volatility in the retirement system year to year").

\(^{124}\)Riva D. Atlas and Mary Williams Walsh, *Pension Officers Putting Billions into Hedge Funds*, NEW YORK TIMES, (Nov. 27, 2005), available at
fund managers. The percentage of European institutional investors placing assets in hedge funds rose from 23% in 2003 to 32% a year later. Worldwide, over $450 billion was invested in funds of hedge funds by 2004, a five-fold increase over the $80 billion invested in funds of hedge funds at the turn of the century. As one author recently commented, "anything which reduces risk, total portfolio volatility and dependence on the long only stock market gamble should be supported." 

Several recent developments in both the hedge fund and pension fund worlds have resulted in making hedge funds sounder investment choices for pension fund managers. The emergence of funds of hedge funds has provided investors with a safer method of hedge fund investment by spreading the risk over several hedge funds. Investment through funds of hedge funds, rather than direct investments in individual hedge funds has three-fold benefits. First, it allows pension fund managers the opportunity to learn more about individual hedge funds before investing in them directly. Second, it may provide pension fund managers with access to individual funds which may otherwise be closed to them as investors. Third, funds of hedge funds offer tailored investment strategies to pension fund managers.

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125 See Laura Cohn, Europe’s Pension Plans: Switching Over to Hedge Funds, BUSINESSWEEK, (May 2, 2005), available at http://www.businessweek.com/print/magazine/content/05_18/b3931148_mz035.htm?chan=gl (noting that European pension funds which had, in the past, relied on equities and bonds, are now looking to hedge funds as a means of diversifying their holdings). Among European companies investing pension assets in hedge funds are BT Group, Railpen (the pension fund for Britain’s rail industry) and endowments at both Oxford and Cambridge. Id.

126 See id.

127 Hedge Funds and Pension Reform, supra note 4.

128 See Cohn, supra note 125 (claiming that most pension funds favor funds of hedge funds as they serve to spread the risk of investment).

129 See id.

130 See id.

131 See id.
Individual hedge funds have also become safer investments as of late, due in large part to the demands being made on them by institutional investors such as pension funds.\(^\text{132}\) Many have grown more cautious in their trading strategies in an effort to attract and keep pension fund investments, making them less risky choices for pension fund managers.\(^\text{133}\)

Lastly, recent developments in pension fund infrastructure have made pension funds better suited to be hedge funds investors\(^\text{134}\) as pension funds have developed more expansive middle and back office that are now equipped to deal with "hedge fund pricing and accounting and valuations of hedge funds."\(^\text{135}\) Strides have also been made in internal risk management procedures.\(^\text{136}\) And, finally, both fund administrators and consultants are expanding the services they provide to pension funds, making them better suited to advising pension plans on hedge fund investments.\(^\text{137}\)

**B. Cons of Pension Fund Investment in Hedge Funds**

For every benefit of pension fund investment in hedge funds mentioned above, opponents of such investments stand ready with a corresponding drawback. They too point to the historical number of retirees emerging from the baby boomer generation, but do so to stress the importance of being more careful with pension plan assets now that such a large portion of the population is relying on them as sources of income.

\(^\text{132}\)See supra note 31 and accompanying text.
\(^\text{133}\)See Atlas and Walsh, supra note 124 (noting that in an effort to attract pension assets, hedge fund managers have begun highlighting the stability of their funds).
\(^\text{134}\)See Maggie Shea, *Pensions' Taming of the Hedge Fund*, CAIA ASSOCIATION, (Nov. 12, 2007), available at http://www.caia.org/news/pensionstamingof_109 (pointing out that due to these recent changes, pension funds are "now more able to accommodate hedge funds").
\(^\text{135}\)Id.
\(^\text{136}\)See id.
\(^\text{137}\)See id. (reporting that fund administrators now offer "software expertise" to pension plan clients that are considering investing in hedge funds and that consultants are often creating in-house departments to deal solely with hedge fund investments).
Opponents point out that few Americans have enough in investments to rely on for retirement income and argue that the little they do have should not be risked on investments in hedge funds. However, critics fail to account for the fact that retirees should also not concentrate their holdings in equities alone (as they could lose the entirety of their investments should the markets tank) or bonds alone (as these are unlikely to produce sufficient returns to support a retiree). Taking an all or nothing approach, they overlook the fact that a balanced portfolio should include modest investments in hedge funds as a means of both balancing the risks of market exposure and producing superior returns.

Opponents of hedge fund investing by pension funds are also quick to point out that the diversification benefits offered by hedge funds are not great enough to make investing in them a sound choice on the part of pension fund fiduciaries. They warn investors that such benefits all but disappear during times of extremely distressed markets, which, they remind, are the times when diversification is needed the most. Again, however, their argument proves too narrow, ignoring the fact that few pension funds invest in hedge funds solely for the diversification opportunities they offer.

Critics also refute claims that pension funds have, of late, become better prepared to make the decision to invest in hedge funds. They describe pension funds as still being

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138 See Robert Hockett, What Kinds of Stock Ownership Plans Should There Be? Of ESOPs, Other SOPs and "Ownership Societies," 92 CORNELL L. REV. 865, 884 (2007). A favored weapon among opponents is the case of the San Diego County pension fund, which suffered nine-digit losses when Amaranth, a hedge fund in which it had invested a portion of its assets, experienced $6 billion in losses. See Edward Pekarek, Comment, Pruning the Hedge: Who is a "Client" and Whom Does an Adviser Advise, 12 Fordham J. Corp. & Fin. L. 913, 953 (2007). However, few opponents will include in their remarks about the Amaranth disaster the fact that the San Diego County fund still saw an increase in returns of over 14% that year or the fact that the fund still has 15% of its asset invested in hedge funds. See Klunk, supra note 7, at 4.

139 See supra notes 19 and 20 and accompanying text.

140 See note 182, infra.

141 See note 181, infra.

142 See section III.A, infra (discussing the many benefits offered to pension funds by investing in hedge funds).
"too understaffed and unsophisticated to act as a check on hedge funds." They criticize pension funds for relying on consultants who "don’t know nearly enough" for hedge fund recommendations. As a result, opponents continue, unwise investments in hedge funds could result in losses which will need to be made up for by increased employer contributions. This argument, however, ignores the recent trends among pension administrators and consultants to better prepare themselves to serve their clients in aiding with hedge fund investment choices, as discussed above. This cannot be expected to be an overnight transformation, but rather is a process that should succeed given a little patience. As plan service providers gradually become more knowledgeable about hedge fund investments, pension funds will gradually become better equipped to make investment decisions regarding them.

In perhaps their strongest and most persuasive claim against the propriety of pension funds investing in hedge funds, opponents argue that such investments should not be allowed because, in the end, it’s the pension beneficiary - the party that had no voice in the decision to invest in a hedge fund - that is hurt when hedge fund investments result in losses. They rightfully point out that while pension funds qualify as sophisticated investors due to their wealth, and are thus exempt from securities laws, it is the beneficiaries of these plans - people who are seldom wealthy - that ultimately are

144 See id.
145 See Baucus, Grassly Question Hedge Fund Investments for American Workers’ Pension Plans, (March 1, 2007), available at http://www.senate.gov/~finance/press/Bpress/2007press/prb030107c.pdf (noting that plan sponsors are hurt when they are forced to increase plan contributions to cover losses incurred in risky hedge fund investments).
146 See supra note 137 and accompanying text.
147 See Dustin G. Hall, Note, The Elephant in the Room: Dangers of Hedge Funds in our Financial Markets, 60 FLA. L. REV. 183, 216 (2008) (noting that the beneficiaries whose money is at risk are neither wealthy nor sophisticated).
losing the protections normally afforded to them by the securities laws. It is these people - the public school teachers, the police officers and the firefighters - that are harmed when investments in hedge funds prove unwise, not the wealthy pension plans that made the decision to invest in the hedge funds.\footnote{See id. (remarking on the fact that pension funds qualify as "sophisticated investors" based on their level of wealth, not their level of knowledge of securities investments).}

This is perhaps the hardest argument for proponents of hedge fund investments to refute for the simple fact that hedge fund investments can result in losses and innocent pension beneficiaries have been hurt.\footnote{See Pekarak, supra note 138, at 953 (describing such people as "entirely antithetical to the concept of the so-called 'sophisticated investors'").} But again, as before, the answer can be provided in one word - moderation. Few, if any, of the proponents of investing pension fund assets in hedge funds would recommend that a pension plan invest one hundred percent of its assets in hedge fund or funds of hedge funds. Rather, they advocate placing a modest portion of pension assets in one or more individual hedge funds or funds of hedge funds as a means of achieving diversification and market neutrality, and in the hopes of earning greater than average returns on their investments.

C. Ways to Make Hedge Funds Safer Investments of Pension Funds

Perhaps the greatest step that can be taken towards making hedge funds safer investment choices for pension funds is to increase the transparency of hedge funds. However, that is more easily said than done. When, in 2005, the SEC enacted a rule requiring hedge fund managers to register with the SEC, it was met with tremendous opposition by the hedge fund industry\footnote{See supra note 138 (discussing the magnitude of the losses suffered by the San Diego County pension fund as a result of the collapse of Amaranth).} and eventually saw its rule overturned by the

\footnote{See Registration Under the Advisers Act of Certain Hedge Fund Advisers, supra note 3, at 6. (reporting that more than half of the comments received by the SEC on its proposed rule opposed passage of the rule).}
D.C. Circuit court. However, many hedge fund managers are registering with the SEC on a voluntary basis as of late, in an effort to make themselves more attractive to pension funds. As noted above, registration with the SEC automatically creates increased transparency since registered funds are required to supply prospectuses to investors and must file quarterly reports with the SEC. Thus, transparency may gradually increase through the voluntary actions of hedge managers, as they seek to secure greater investments of capital by pension managers.

Another option for improving transparency would be to require greater disclosure on the part of hedge funds who have a certain percentage of their assets coming from pension funds. Hedge funds surpassing that threshold would have to disclose information such as their investment strategies, asset allocations and past fund performance.

Hedge funds could also take steps to provide pension funds with safe exit options should the hedge funds enter a period of negative performance or encounter other problems. Many pension fund fiduciaries are leery of committing assets to hedge funds since they then become subject to lock-in periods - which would deny them the freedom to withdraw their investment before the expiration of a set period of time - and the

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153 See Waddell, supra note 117 (noting that because pension fund fiduciaries are required to be “prudent in selecting managers,” managers who are registered with the SEC are often more appealing choices for fiduciaries”).
154 See, e.g., note 36, supra.
155 In fact the Hennessee Group has suggested exactly that, supporting a “market-driven” approach to the registration of hedge fund advisers. See Gradante, supra note 11, at 12. Hedge funds seeking pension fund investors should have to register before being able to accept contributions from pension funds. Id.
156 See Daniel, supra note 7, at 309-310 (suggesting more detailed disclosure requirements be enacted for hedge funds consisting of a certain percentage of pension fund assets).
157 See id.
possibility of steep exit charges in the event they decide to withdraw their assets early.\textsuperscript{158} A possible solution to this problem would be for hedge funds to enter into side letter agreements with pension funds, permitting them to enjoy shorter lock-in periods and reduced - or waived - exit charges. This would presumably be a small price to pay on the part of hedge funds in exchange for their receiving the massive amounts of capital pension funds have to invest. It would, at the same time, appease pension fund fiduciaries by providing them with a means of quick escape should problems arise within a hedge fund in which they have invested.

There are also steps which can be taken on the pension fund side of things. Limits could be placed on the percentage of fund assets which pension fiduciaries are permitted to invest in hedge funds.\textsuperscript{159} ERISA could require increased disclosure on the part of pension funds, mandating that they disclose to beneficiaries the number of hedge funds in which they have invested pension fund assets, as well as the amounts invested in each.\textsuperscript{160} Finally, and perhaps most importantly, pension fund fiduciaries could be better educated about the risks and benefits of investing in hedge funds. It has even been suggested that pension funds be required to hire Chief Investment Officers to oversee investment choices in response to claims that pension plan trustees devote too little time


\textsuperscript{159}See Daniel, supra note 7, at 307-08 (clarifying that this would limit pension funds from investing more than a certain percentage of assets in hedge funds, rather than limit hedge funds from accepting more than a certain percentage of assets from pension funds); see also Jacob Preiserowicz, Note, The New Regulatory Regime for Hedge Funds: Has the SEC Gone Down the Wrong Path?, 11 FORDHAM J. CORP. & FIN. L 807, 841 (2006) (suggesting that any regulation of the investment of pension assets in hedge funds should be done by the Department of Labor through ERISA).

\textsuperscript{160}See Gradante, supra note 11, at 5 (noting that ERISA currently contains no such requirements); see also Atlas & Walsh, supra note 124 (reporting that the employees of many companies have no idea that their pension money is being invested in hedge funds). For example, International Paper's annual reports list the company's hedge fund holdings only as "other." \textit{Id}.
to making investment decisions. This would be an easy and effective method of ensuring that pension fiduciaries understand the choices they are making and are acting in accordance with their fiduciary duties.

D. Questions Pension Fund Fiduciaries Should Ask Before Investing in Hedge Funds (Tuesday)

A recent article appearing on a pension and investment website suggests that before pension fund fiduciaries decide to invest in a hedge fund, they should “subject themselves to hypothetical cross-examination” in an effort to determine whether such an investment is in the best interests of plan beneficiaries. The following is a list of the recommended questions to be asked:

- *Are you permitted to hold this type of investment?*

Such a question serves to remind the fiduciary that while there are few statutes and regulations that specifically dictate what can and cannot be invested in, there are still other sources that govern the types of investments a fiduciary may make. For instance, ERISA requires that investments be “prudent.”

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161 See Chong, *supra* note 118 (lamenting the fact that pension fund trustees seldom challenge the advice of investment consultants because they themselves know too little about the subject matter and have few incentives to raise challenges); Tse, *supra* note 115 (complaining that the questions asked by pension fund managers are often "too basic"); Cohn, *supra* note 125 (reporting that Nestle has gone as far as hiring in-house staff whose sole job it is to investigate hedge fund investments, including research into strategies used by funds, how funds operate and the background of fund managers).


163 *Id.*

164 See Klunk, *supra* note 7, at 5 (noting that ERISA supplies very few restrictions on the investments which a pension fund can make).

165 See Stewart, *supra* note 158, at 8 (defining the prudent person rule as requiring "pension fund fiduciaries to invest 'in accordance with the prudential principals of security, profitability, and liquidity'").
documents which may govern the pension plan, as well as the plan’s investment policy statement, may also disallow investments in hedge funds.\textsuperscript{166}

- \textbf{Do you believe financial markets are inefficient and that such inefficiencies are exploitable?}\textsuperscript{167}

As discussed above in Section I, hedge funds operate based upon a strategy designed to uncover and exploit market inefficiencies.\textsuperscript{168} If a fiduciary does not believe such exploitation is possible, then there is little or no reason for a fiduciary to risk investing pension assets in a hedge fund. The main reason pensions invest in hedge funds is diversification.\textsuperscript{169} If the fiduciary does not believe that hedge funds are uniquely capable of exploiting market inefficiencies, then they must not believe hedge funds differ from any other investment vehicle, making investment in hedge funds unnecessary for achieving diversification.

- \textbf{Can you adequately evaluate the positions held in the hedge fund investment and the associated risks of those positions?}\textsuperscript{170}

As discussed in-depth above, hedge funds are among the least transparent investment vehicles in the market.\textsuperscript{171} However, as also noted above, large institutional investors such as pension funds often wield enough power to demand and receive greater disclosure from hedge funds than ordinary investors may be able to secure.\textsuperscript{172} Provided the fiduciary has the means to make such demands, and is willing to do so, this issue should not present too great a hurdle to fiduciaries of large pension funds.

\textsuperscript{166}See Aikin, supra note 162 (“[I]aws, regulations, trust documents, the investment policy statement and other instruments of authority might have provisions that would preclude hedge fund investing”).

\textsuperscript{167}See id.

\textsuperscript{168}See, e.g., supra note 16 and accompanying text.

\textsuperscript{169}See Aikin, supra note 162 (noting that the “bedrock fiduciary principle of investing is diversification”).

\textsuperscript{170}See id.

\textsuperscript{171}See supra notes 71-72 and accompanying text.

\textsuperscript{172}See supra note 68 and accompanying text.
• Are the fees and expenses of the hedge fund fair and reasonable?\textsuperscript{173}

Fiduciaries must be sure they fully comprehend the fee structure of the funds in which they are investing\textsuperscript{174} and must also be watchful for instances of fee layering if investing in funds of hedge funds.\textsuperscript{175}

• What recourse do you have if something goes wrong?\textsuperscript{176}

This question is intended to raise the fiduciary’s awareness of the fact that many hedge funds keep their assets in off-shore accounts, most commonly in the Cayman Islands.\textsuperscript{177} Should something go awry with such assets, they may be outside the jurisdiction of US courts.

While this list of questions may not capture every consideration that should be taken into account by a pension fund fiduciary in deciding whether to invest assets in a hedge fund, it does, at the very least, provide a good place to start.

**Conclusion**

Provided that pension fund fiduciaries carefully evaluate the risks and rewards of investing pension assets in hedge funds and determine that the investments are in the best interest of pension fund beneficiaries, such investments should not be considered breaches of fiduciary duty. Hedge funds can be valuable diversification tools for pension funds and, due to their market neutrality, can go a long way towards ensuring that

\textsuperscript{173}See Aikin, supra note 162.
\textsuperscript{174}See supra note 25 and accompanying text (detailing the typical fee structure of hedge funds).
\textsuperscript{175}See supra notes 73 and 74 and accompanying text (describing the practice of fee layering).
\textsuperscript{176}See Aikin, supra note 162.
\textsuperscript{177}See id. (warning that “[t]he assets of most hedge funds are held in off-shore custodians. The No. 1 location of custody is the Cayman Islands.”).
pension funds have an opportunity to experience positive returns even during times of market downturns.  

This does not mean that each and every pension fund should dive headlong into hedge fund investment. Hedge funds, by nature, are actively managed investment vehicles. Thus, only pension fund managers who are seeking actively managed investments, and who believe that hedge funds are the best forms of such investments, should choose to invest in hedge funds. Nor should pension fund managers choose just any hedge fund to invest in. The hedge fund must be able to produce positive returns in order to be a wise investment choice on the part of pension funds. While there are diversification benefits to be gleaned from hedge fund investments, these benefits are lessened during sharp market downturns. Therefore, diversification benefits alone should not be the reason a pension fund chooses to invest in a hedge fund; a fund must also be able to produce positive returns as well.

If, after careful consideration, pension fund fiduciaries deem it a wise choice to invest in hedge funds, there are still investment details that need to be ironed out. Fiduciaries must be diligent in determining what percentage of pension fund assets would be appropriate to allocate to hedge fund investments, which type of hedge fund strategy

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178 See Atlas & Walsh, supra note 124 (noting that many pension officers, in the wake of market downturns, are being attracted to hedge funds because of their promises of more reliable returns).

179 See Robert Howie, *Hedge Fund Investing by Pension Funds*, MERCER, (Dec. 3, 2007), available at http://www.mercer.com/common/printfriendlypage.html;jsessionid=JL3DRA01WIBAG (reminding readers that “hedge funds are aiming to make the most of their return from active management”).

180 See id. (advising that only “pension funds that believe in active management, and are convinced that some of the best active managers can only be accessed via hedge funds” should invest their assets in hedge funds).

181 See id. (preaching that more than anything else, hedge funds should produce returns for investors).

182 See id. (noting that the diversification benefits provided by hedge funds are reduced “in times of extreme equity downturns,” which also happens to be the point at which diversification is needed the most).

183 See id. (describing the diversification benefits of hedge funds as moderate at best).
best suits their needs, and whether to invest in a hedge fund directly or a fund of hedge funds.184

Once comprehensive research has been completed, adequate disclosures have been made and any and all questions have been thoughtfully and thoroughly considered, pension fund managers should be free to invest pension assets in hedge funds. Despite the attendant risks of hedge fund investment (and, let's be honest, what investment doesn’t have its risks?), hedge funds have much to offer pension fund investors by way of diversification, the chance for higher than average returns, the flexibility to act quickly and the freedom to try creative new investment strategies and techniques. It would seem, therefore, that there is a stronger case for breach of fiduciary duty for not investing in hedge funds, as such a choice would rob pension beneficiaries of their greatest opportunities for financial reward.185 As recently stated, "[a] pensions scheme that won't invest in hedge funds is similar to a surgeon who won't use anesthesia except the financial pain will likely last longer.”186

184See Howie, supra note 179 (specifying that pension funds must determine "how much to allocate, which strategies to use (e.g., arbitrage, long/short equity, etc.), and what sort of hedge fund vehicle to use").
185See Pension Funds Need Hedge Funds, supra note 116 (claiming that "not investing in hedge funds is not prudent").
186See id.