

September 16, 2008

## **SIGNIFICANT CHANGES IMPOSED IN PENSION PLAN VALUATION OF ALTERNATIVE INVESTMENTS**

The Boston office of the Department of Labor (the "DOL") recently delivered an unpleasant surprise for pension plan investors in private equity funds, hedge funds, and other alternative investments. In a July 1, 2008 letter to an unidentified pension plan, James Benages, the director of the DOL's Boston office, contends that a pension plan's method of valuing its alternative investments (limited partnerships and joint ventures) was not in the best interest of the plan's participants and beneficiaries and violated Section 404(a)(1) of ERISA.

The plan reported the value of its alternative investments on its Form 5500 by relying on financial information received from its investment adviser and/or the general partner of the underlying alternative investment entity. In one case, the value was based on a general partner's "unaudited Capital Account Balance Statement" and audited financial statements; in another case, an alternative investment was valued according to the unaudited determination of fair market value by the general partner, without "any further analysis to ascertain whether the unaudited fair market value accurately reflected the true value of the asset."

The Boston office criticized these valuation methods and opined that the plan must "establish a process to evaluate the fair market value of any hard to value assets," including "a complete understanding of the underlying investments and the fund's investment strategy." The letter further decreed that the plan "must have a thorough knowledge of the general partner's valuation methodology to assure it ... reflects fair market value. A process which merely uses the general partner's established value for all funds without additional analysis may not insure that the alternative investments are valued at fair market value." According to the letter, the plan's "failure to have an established process by which the fair market value of alternative investments can be determined violates ERISA" and if not changed, could result in a lawsuit brought by the DOL.

If the Boston office's position is adopted by the DOL, ERISA plans may be reluctant to invest in such alternative investments which do not have an established defensible method for determining value. Because many private equity / investment funds provide little transparency with respect to their investment positions and valuation methods, if plan fiduciaries cannot rely on the valuations provided by the managers of such funds, they may well determine that such investments are not permissible. Alternatively, plan fiduciaries may be required to undertake significant due diligence to obtain an independent valuation of alternative investments. While the letter does not describe how a plan may conduct an independent valuation, such a process is likely to involve obtaining considerable supplementary information from the investment funds, requesting the investment funds to conduct an independent appraisal, and hiring appraisal firms, investment banks, or in-house advisors with appraisal expertise.

If you would like to discuss this development or have any questions regarding the foregoing, please feel free to contact one of the attorneys listed below.

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