K&LNG Alert

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ERISA Fiduciary

New "Plan Asset" Rules for Unregistered Funds

The "Pension Protection Act of 2006" (the "Act"), passed by Congress and awaiting the President's signature, makes the most significant changes to standards governing the conduct of employee benefit plan investment managers and other fiduciaries since the enactment of the Employee Retirement Income Security Act of 1974 ("ERISA") over three decades ago. This Alert focuses on the impact the Act will have on unregistered investment funds (herein, "private funds") and their sponsors, advisers, and managers.[1]

For the past twenty years, private fund managers that permit investment by plans subject to ERISA have looked to a regulation issued by the U.S. Department of Labor ("DOL") to determine whether the assets of their funds are to be treated as "plan assets" for purposes of ERISA (the "Regulation"). The Act makes major changes to the now-familiar "25% test" under the Regulation.

In short, the changes—*which take effect with respect to transactions occurring after the date of enactment*—may permit private fund managers to raise significantly more capital from ERISA plans without being subject to the fiduciary standards of ERISA, the prohibited transaction restrictions of ERISA, or the parallel prohibited transaction provisions of Section 4975 of the Internal Revenue Code of 1986 ("Code").[2] The changes also permit ERISA plans to take advantage of opportunities to invest in private funds that may have been unavailable to them up to now.

As discussed below, the Act potentially affects not only standard "hedge funds," but also bank-sponsored common and collective trust funds, insurance company separate accounts, and "group trusts" that include ERISA plans as participants.

The remainder of this Alert describes the relevant provisions of the existing Regulation, changes to the 25% test made by the Act, certain plan-asset rules not changed by the Act, and certain practical implications and considerations for fund managers resulting from the changes.

THE REGULATION

The Regulation provides that the assets of a private fund—*i.e.*, a privately offered investment fund not registered under the Investment Company Act of 1940—are treated as "plan assets" of investing plans subject to ERISA, if, immediately after the most recent acquisition of an interest in the fund, "benefit plan investors" in the aggregate own 25% or more of the value of any class of equity interests in the fund. This is known officially as the "significant participation" test under the Regulation, but we refer to it here simply as the "25% test."

[1] Act Section 611(f) adding ERISA Section 3(42). Client alerts covering other provisions of the Act, including those dealing with "investment advice" provided to participants of 401(k) plans and other significant changes to the prohibited transaction restrictions of ERISA and the parallel prohibited transaction excise tax provisions of Section 4975 of the Internal Revenue Code of 1986 (the "Code") will be distributed shortly.

[2] The Regulation contains rules for determining when the assets of an unregistered fund are to be treated as "plan assets" for purposes of both ERISA and the prohibited transaction excise tax provisions of Code Section 4975. Certain retirement arrangements and plans, such as individual retirement accounts and plans covering only self-employed individuals, are not subject to ERISA, but are subject to Code Section 4975. Unless indicated otherwise, references below to plans subject to ERISA and to assets of funds treated as "plan assets" for purposes of ERISA generally are intended to include plans and fund assets subject to Code Section 4975.

"Benefit plan investors" are defined to include not only plans subject to ERISA and Code Section 4975 (such as individual retirement accounts and plans covering self-employed individuals), but also other employee benefit plans not subject to those statutes. The latter category includes a wide variety of employee benefit plans, such as governmental plans, church plans, and foreign plans.

Former 25% Test—Example 1

Private fund (Fund A) has a single class of equity interests and total assets of $10 million. ERISA plans hold equity interests in Fund A having a value of $2 million; government plans hold $2 million; non-plan investors hold the remaining $6 million. Since benefit plan investors, as defined, hold 25% or more of the equity interests in Fund A (in this case 40%), the assets of Fund A are treated as "plan assets."

The term "benefit plan investor" also includes a private fund or other entity whose assets are treated as "plan assets." Thus, Fund A in Example 1 would itself be considered a "benefit plan investor" if it were to invest in another fund.

Former 25% Test—Example 2

Fund A invests in another private fund (Fund B). Fund B has a single class of equity interests and total assets of $10 million. Fund A holds equity interests in Fund B with a value of $2 million; foreign plans hold $2 million of equity interests in Fund B; non-plan investors hold the remaining $6 million. Since benefit plan investors, including Fund A and the foreign plans, hold 25% or more of the equity interests in Fund B (in this case, 40%), the assets of Fund B are treated as "plan assets."

The Regulation also includes a special rule that provides that the assets of certain other types of unregistered funds in which ERISA plans may hold interests always are treated as "plan assets," regardless of the percentage of equity interests held by "benefit plan investors." These include common or collective trust funds of banks, separate accounts of insurance companies (if maintained in connection with obligations of the insurance companies that vary according to the performance of investments held in the separate accounts), and "group trusts" for corporate and governmental employee benefit plans described in Revenue Ruling 81-100,[3] regardless of the identity of the sponsor or manager of the group trust.

Former 25% Test—Example 3

Investment adviser (IA) sponsors and manages a group trust fund (Group Trust) for employee benefit trusts described in Revenue Ruling 81-100 (and which qualify under applicable securities law exemptions). The Group Trust has total assets of $10 million. ERISA plans hold equity interests with a value of $2 million; government plans hold the remaining $8 million. The assets of the Group Trust are treated as "plan assets" under the special rule of the Regulation.

Former 25% Test—Example 4

Bank maintains a common trust fund (CTF) with total assets of $10 million. The CTF consists of trusts (for which Bank acts as trustee) established by or for tax-exempt organizations described in Code Section 501(c). Trusts of "voluntary employees' beneficiary associations" subject to ERISA ("VEBAs")[4] hold CTF interests with a value of $2 million; trusts of other tax-exempt organizations that are not employee benefit plans hold the remaining $8 million. The assets of the CTF are treated as "plan assets" under the special rule of the Regulation.

Another application of the "plan assets" concept involves insurance company general accounts. A 1993 Supreme Court decision held that general account assets not backing contracts providing for guaranteed benefits could be considered "plan assets," thereby subjecting the insurance company to ERISA in regard to the management of those assets. The DOL has indicated that only the portion of an insurance company general account's equity investment in a private fund or other entity that represents "plan assets" need be taken into account in the computation of the fund's 25%.

THE NEW "25% TEST"

The Act states that the term "plan assets" is to be defined by DOL regulations. The Act also specifically provides, however, that the assets of an entity are *not* to be treated as "plan assets" unless the entity passes (or fails, depending on your point of view) a newly revised 25% test described below:

[3] Revenue Ruling 81-100 has been clarified and modified by Revenue Ruling 2004-67.

[4] VEBAs are employee welfare benefit plans exempt from taxation under Code Section 501(c)(9).

First, *only* plans subject to ERISA or Code Section 4975 are to be taken into account.

Revised 25% Test—Example 1

In Example 1 above, the assets of Fund A would not be treated as plan assets because ERISA plans hold less than 25% (in that case, 20%) of the interests.

Second, *only that portion* of the assets of a plan-assets fund that is attributable to investing ERISA plans is taken into account for purposes of applying the 25% test to another private fund in which the first fund invests.

Revised 25% Test—Example 2

Assume the same facts as described in Examples 1 and 2 above, except that ERISA plans hold equity interests in Fund A with a value of $3 million, representing 30% of the total interests in Fund A. Fund A invests $2 million in Fund B, which has a single class of equity interests and total assets of $10 million. Other equity interests in Fund B are held by foreign plans ($2 million) and non-plan investors ($6 million). Under the 25% test as revised by the Act, the assets of Fund A are treated as "plan assets," and Fund A is the only benefit plan investor in Fund B (*i.e.*, the foreign plans are no longer considered benefit plan investors). Moreover, Fund B would be required to include for purposes of its 25% test only that portion of Fund A's investment that is attributable to ERISA plan investors (30% of $2 million), or $600,000. Since benefit plan investors (*i.e.*, the portion of Fund A attributable to ERISA plans) hold only 6% of the equity interests in Fund B ($600,000 of $10 million in Fund A), the assets of Fund B are not treated as "plan assets."

Finally, the revised 25% test applies to "any entity." None of the Act, the Regulation, or ERISA defines the term "entity." It is reasonably clear from the Regulation as a whole, however, that the term contemplates investment vehicles and arrangements of all kinds, regardless of legal form or structure.

Revised 25% Test—Examples 3 and 4

Under this interpretation,[5] the assets of the Group Trust in Example 3 and the CTF in Example 4 above would not be considered "plan assets" because, in both cases, ERISA plans hold less than 25% of the equity interests in the fund (in each of those cases, 20%).

CONTINUING RULES

Other rules affecting the status of investment vehicles under ERISA are not changed by the Act. Among those worth noting are the following:

- As is the case under the existing Regulation, the revised 25% test is to be applied to each "class" of equity interests in a fund (a term not defined in either the Act or the Regulation). Moreover, any interests held by the fund manager (or an affiliate), other than through a benefit plan investor, are to be disregarded in making the computation.
- The Act makes no changes to existing statutory exclusions applicable to mutual funds and other investment companies registered under the Investment Company Act of 1940. The assets of these funds will continue not to be treated as plan assets, and mutual fund advisers will not be considered ERISA fiduciaries solely because ERISA plans are investors or shareholders in such funds.
- The Act does not change the rules applicable to insurance company general account investments in funds. If anything, the Act's requirement—that only the proportion of a plan-asset fund or other entity that is attributable to ERISA plans is to be counted in the computation of the 25% test for another fund in which the first fund invests—is consistent with the view that the proportionate counting of "plan assets" in insurance company general accounts should include plans subject to ERISA and Code Section 4975 only.

PRACTICAL IMPLICATIONS

A determination that fund assets are "plan assets" for ERISA purposes has critical regulatory ramifications for the fund manager. Most importantly, the manager of a plan-asset fund is considered a "fiduciary" under ERISA with respect to each of the investing ERISA plans.

An ERISA fiduciary is expected to conform with ERISA's fiduciary standards and prohibited transaction restrictions in managing fund investments and transactions. Investing ERISA plans generally will expect the manager to acknowledge its fiduciary status and provide reasonable assurances that the manager will conform

[5] Although the scope of its rulemaking authority is not completely clear, it appears the DOL may have at least some residual authority to interpret or define the term "plan assets." Consequently, private fund managers should be watchful for any clarifications or refinements of the subject the DOL may propose in the future.

with applicable ERISA standards. Managers of "plan-asset" private funds also may be expected to represent that they meet the requirements of a "qualified professional asset manager" ("QPAM") for purposes of a DOL class exemption that permits a plan-asset fund to engage in various types of transactions that otherwise might be prohibited. Moreover, ERISA's regulatory regime will govern the management of the fund, even though many of its investors may not be ERISA plans.

Many private fund managers up to now have sought to avoid the complexities associated with ERISA compliance and other practical difficulties by voluntarily restricting investments by employee benefit plans of all kinds to less than 25% of their funds. Many others have designed their funds to become subject to and compliant with ERISA, and thereby increase investments by ERISA and other plans. As a result of the changes described above, however, all managers will have the opportunity to rethink their business and regulatory compliance strategies.

Clearly, the Act's principal impact will be to relieve a potentially significant number of unregistered fund managers from initial or continued compliance with ERISA's fiduciary duty and prohibited transaction requirements. Managers that have restricted plan investments in order to avoid the application of ERISA will be in a position to permit potentially substantial additional investments by plans while continuing to avoid the application of ERISA. Managers of funds that have been subject to ERISA to this point have a number of practical issues to address:

- How does the revised 25% test apply to and affect my fund(s)?
- If the assets of my funds are no longer treated as ERISA plan assets, do I terminate the ERISA compliance procedures that have been adopted and followed to this point (including, *e.g.*, compliance with the QPAM exemption and other prohibited transaction exemptions)?
- If so, how and when should those procedures be changed?
- How and when do I inform fund investors about the changes?
- What changes, if any, should be made to the fund's governing documents (offering memoranda, subscription agreements) or agreements with third parties (prime brokerage agreements, etc.)?
- Do I have adequate information in regard to the proportionate ownership by ERISA and Code Section 4975 plans of fund-of-funds investors in my fund and can I monitor such information accurately over time?

A practical consideration that should not be overlooked in the transition process relates to the continued need to monitor fund investors continuously and accurately. The Act does not change the requirement that the 25% test be applied on an ongoing basis, after each initial or additional investment in the fund. Thus, the need to monitor changes in the identity and holdings of fund investors so as to ensure the 25% test is computed accurately continues under the revised rules. This can be particularly challenging in the case of "open end" funds that permit investments and redemptions on a periodic, ongoing basis. The task of monitoring is even greater where eligible investors include other funds (*e.g.*, funds-of-funds) whose investors include ERISA plans. In all these cases, direct and indirect holdings of fund interests by ERISA plans—and the results of the 25% test—potentially may vary on a day-to-day basis.

Another important consideration relates to governmental plan investors. These plans are regulated by state and local laws that in many cases refer to or may be modeled on ERISA and/or the Regulation. The extent to which the Act affects existing rules applicable to these investors should be assessed on a case-by-case basis.

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The lawyers of our Hedge Fund and ERISA fiduciary practice groups have substantial experience assisting unregistered fund clients with ERISA compliance and related matters, and would be glad to discuss these and other implications of the new rules.

This Alert is a general summary of some of the Act's most important implications for managers of investment vehicles in which ERISA plans invest. Each manager should assess the Act's impact on its own fund(s) in light of the particular facts and circumstances.

If you have any questions or need additional information, please contact a member of the Hedge Fund or ERISA fiduciary practice groups listed on the next page.

Members of the ERISA Fiduciary Group and their telephone numbers and email addresses are listed below. For more information you may also visit our website at www.klng.com.

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