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New Pension Law Relaxes ERISA's 25% Test for Investment Funds, Makes Other Changes

Good news for managers of hedge, venture capital and private equity funds, some structured finance vehicles (CDOs, etc.) and other pooled investment funds in which pension and other employee benefit plans invest: a new pension law provides that foreign and governmental benefit plans will not count against ERISA's 25% test. So, a pooled investment fund won't be subject to ERISA if less than 25% of its outside client money comes from ERISA plans and individual retirement accounts (IRAs), even if the rest of the fund's money comes from governmental or foreign pension plans.

The new Pension Protection Act (H.R. 4) was passed by the House at the end of July and by the Senate on August 3, and is expected to be signed soon by President Bush.

Background. ERISA, the U.S. federal pension law, imposes strict requirements on persons who directly manage money for pension and other benefit plans subject to that law. These duties include the highest standard of fiduciary care and an obligation to avoid self-dealing and other "prohibited transactions" involving persons closely related to the plan whose assets are under management. These standards are imposed by law and cannot be waived by the ERISA plan investor.

The ERISA rules generally apply to managers of pooled investment vehicles (other than registered mutual funds) which accept any investors subject to ERISA. However, three important exemptions can allow managers of some pooled investment vehicles to accept ERISA clients without having to comply with any of the ERISA rules governing fiduciary conduct and prohibited transactions:

1. VCOCs. The typical leveraged buyout or venture capital fund is organized as a "venture capital operating company" or "VCOC". VCOCs invest in operating businesses and get special "management rights" in connection with those investments (director rights or other rights to influence management). The typical hedge fund cannot be a VCOC, because of the management rights requirement.

2. REOCs. A "real estate operating company" or "REOC" is an investment fund which invests in real estate that is being managed or developed, where the REOC has the right to participate meaningfully in the management or development activities.

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3. <u>25% Funds</u>. The ERISA rules do not apply to investment funds which have less than 25% of their outside investments from benefit plans (including IRAs). Under old law, foreign and governmental benefit plans counted against this 25% limit even though they are not subject to ERISA. So, under the old rules, if 10% of the fund's outside assets came from ERISA plans and 20% from foreign and government pension plans, the fund would have failed this "25% Test," and the fund manager would have to comply with ERISA unless the fund were a VCOC or REOC. (Many hedge funds are designed to comply with the 25% Test.)

<u>The New 25% Test</u>. The Pension Protection Act radically changes the 25% Test. Under the new 25% Test, only ERISA plans and IRAs will count toward determining whether a fund meets the 25% Test –governmental and foreign benefit plans will be in the denominator of the testing fraction but not in the numerator. In the example above, the fund failed the old 25% Test but would meet the new 25% Test. **In short, fund managers will be able to raise and manage an unlimited amount of governmental and foreign benefit plan money without risk of needing to comply with the ERISA rules.**

Some old uncertainties about how to apply the 25% Test remain unresolved. For example, except for ERISA plan money, the numerator and denominator of the testing fraction exclude investments in the fund made by the money manager (or related persons); and also exclude, apparently, investments with money that the manager (or related persons) control, perhaps in separately managed accounts or in other funds, but the scope of this rule has never been completely clear. Moreover, the new 25% Test continues to apply separately to each class of equity interest in the fund; in other words, even under the new 25% Test, if 25% or more of <u>any</u> class of equity interest of the fund is held by ERISA plans or IRAs, the <u>entire</u> fund will be subject to ERISA. Still unresolved are the familiar questions of whether certain distinctions among investors must be treated as separate classes of equity for purposes of this class-testing rule, for example, where the distinctions relate only to different fee structures or the ability to participate in "new issues" (aka "hot issues").

<u>When does the new law apply</u>? The 25% Test is applied each time an equity interest in a fund is acquired. The new law literally applies to "transactions" occurring after the date of enactment, but there is no detail in the law or the legislative history discussing the meaning of that term. We think it is likely that the new 25% Test may be used by an existing fund to take it out of ERISA regulation immediately upon and following enactment of the new law, but that is not yet entirely clear. The alternative would be that a fund currently subject to ERISA could not take advantage of the new 25% Test until there is a post-enactment investment in (or possibly, redemption from) the fund, but that would provide for widely disparate treatment of funds depending on where they stand in their lifecycle and be easily subject to manipulation. So, we believe that immediate and uniform application is more likely.

<u>Over 25%?</u> If a fund has 25% or more ERISA money, it can still (i) use the VCOC and REOC rules to avoid ERISA, if it is making the right kind of venture or real estate investments, or (ii) register as a QPAM ("qualified plan asset manager") to get a lower level of ERISA responsibility, an approach increasingly used by some hedge funds. Managers now operating as QPAMs may not be able to use the new 25% Test to change their method of operation in respect of existing clients because the fund documents may require the manager to operate as a QPAM.

More good news, for funds of funds: Where the manager is stuck with plan assets – 25% or more ERISA money – the new law applies a rule of proportionality. For example, if 32% of the assets of a fund of funds is from ERISA clients, then only 32% of its assets count as "ERISA plans" when the underlying funds into which it invests run their own 25% Test. This is more liberal for fund managers than current law, under which, if more than 25% of a fund is comprised of "benefit plan investors" (including governmental and foreign plans), then 100% of the money the fund of funds invests into an underlying fund counts as benefit plan investor money for purposes of the underlying fund's 25% Test.

OTHER NEW LAW RULES

The new Pension Protection Act includes many other provisions affecting benefit plans, plan sponsors and plan money managers. For large employers, the most important changes are probably the new rules on employer minimum funding obligations to defined benefit pension plans. For money managers, apart from the new 25% Test, many of the changes are probably of greatest interest to broker-dealers and financial institutions which deliver support services to ERISA plans. For example, there are some highly technical new rules relating to agency cross trading, securities transactions conducted by electronic communication networks ("ECNs") and certain block trading practices. There are a few new rules worthy of mention here. The first is a relaxation of the prohibited transaction rules, which allows for the first time an ERISA plan to transact business with a party related to the plan solely on account of providing services to it, so long as (i) the compensation paid or received by the ERISA plan in the transaction is not more (if the plan is paying) or less (if the plan is receiving) "adequate consideration" and (ii) the service provider is not managing the ERISA plan money involved in the transaction (and does not have certain types of relationships with the person who is managing the ERISA plan money involved in the transaction). In addition, a special rule, possibly of greatest interest to institutional managers selling retail 401(k) plan products, will allow investment advice services to be offered to participants in conjunction with investment product offerings, so long as (among other requirements) either the fees paid for the advice do not vary depending on the investment selected or the advice is provided through an unbiased computer model, and an independent fiduciary authorizes the advice program. Also, the required bond for ERISA fiduciaries would no longer be required of most broker/dealers, and where required the amount has been raised to a maximum of $1 million (from $500,000). Finally, in certain circumstances, some prohibited transactions can be corrected within 14 days after discovery (or when discovery could have reasonably been made) without penalty taxes being imposed. Interestingly, many of the changes affecting the financial services industry could have been achieved by Department of Labor regulation rather than by legislation.

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For more information on the new Pension Protection Act and its application to investment funds, please contact:

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