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What to Do if Your Fund Becomes Subject to ERISA

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This article discusses, in general terms, certain of the ramifications under both the Employee Retirement Income Security Act of 1974, as amended (ERISA) and the prohibited transaction rules under Section 4975 of the Internal Revenue Code of 1986, as amended (the Code), to investment vehicles, such as hedge funds, that are deemed to hold “plan assets” under the US Department of Labor’s (the Department) regulations as modified by ERISA section 3(42)¹ (Funds). A previous version of this article appeared in the June 2006 issue of *The Investment Lawyer*. This article has been updated to reflect recent developments in the law.

As ERISA’s fiduciary standards and the prohibited transaction rules under both ERISA and the Code apply to fiduciaries, which is defined to include persons who have discretionary control or authority over plan assets or render investment advice for a fee with respect to plan assets, Fund investment managers and advisers become fiduciaries and subject to such provisions by reason of their advisory duties, where they are dealing with plan assets. As the Code contains prohibited transaction provisions that are substantially simi-

lar to those of ERISA, for the remainder of this article and unless provided otherwise, references to ERISA’s prohibited transaction rules shall include the corresponding Code provisions.

Plan Assets

As ERISA applies a “functional” definition of who is a fiduciary, which turns on whether a person is dealing with “plan assets,” much depends on identifying plan assets. The concept of “plan assets” is fairly complex and highly technical. Generally, the concept was developed to provide guidance as to when a plan investment constitutes an arrangement for the indirect provision of investment management

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services, as opposed to an investment in an entity with the purpose of generating profits through its operations. In other words, this provides a “look-through” rule for applying ERISA to certain entities that are not themselves employee benefit plans. If an entity is deemed to hold plan assets, each ERISA plan (or plan within the meaning of Code section 4975) that invests in such entity is deemed to hold an undivided interest in its underlying assets, and the managers of the entity generally will be considered fiduciaries for purposes of applying the prohibition transaction rules and ERISA’s fiduciary requirements.

First, ERISA section 401(b)(1) provides that where a plan invests in securities issued by investment companies registered under the Investment Company Act of 1940, as amended (1940 Act) the assets of the plan include such securities but not the assets of the investment company. Second, ERISA section 401(b)(2) provides that plan assets include a plan’s investment in certain types of insurance contracts but not the assets of the insurer. By negative implication, other entities that are not specifically carved out by the statute do hold plan assets.

To clarify the definition of plan assets and provide guidance as to how to identify entities that hold plan assets, the Department adopted its “plan assets regulation.” As stated in the preamble to the plan assets regulation, the regulation “reflect[s] a general policy determination that the fiduciary responsibility provisions of [ERISA] should apply to an entity in which a plan invests only if: (1) the plan’s investment is such that it has an opportunity to participate in the earnings of the entity; (2) the entity itself is an investment fund; and (3) there is some indication that interests in the entity are offered especially to plans.”²

As noted, the “plan assets” concept is a look-through rule. The plan assets regulation provides that an entity will be deemed to hold plan assets if:

- The plan’s investment is an “equity interest;”
- The investment is not a “publicly-offered security;”
- The issuer is not registered as an investment company under the 1940 Act;
- The issuer is not an “operating company;” and
- Equity participation by “benefit plan investors” is “significant.”

Although some unregistered investment funds, such as private equity and real estate funds, can avoid being deemed to hold plan assets by qualifying as special types of operating companies under the plan assets regulation, known as VCOCs for “venture capital operating companies” or REOCs for “real estate operating companies,” which each require a certain level of management authority over their portfolio investments, most unregistered funds that avoid holding plan assets do so by ensuring that participation by benefit plan investors remains insignificant. In short, the plan asset regulation provides that participation by benefit plan investors is not significant where benefit plan investors own less than 25 percent in value of each class of equity interest in the investment fund (the so-called 25 percent rule). Shares owned by the fund’s investment manager, adviser, or any affiliate thereof (or any other person with discretionary authority or control over the investment of the fund’s assets or a person who provides the fund investment advice for a fee) are disregarded from such calculation. The calculation is done each time fund shares are issued or redeemed.

As so much depends on how the 25 percent rule is calculated, Congress, after much lobbying, stepped in to clarify the rule. The Pension Protection Act of 2006 (PPA), enacted August 17, 2006, adds section 3(42) to ERISA in order to modify the Department’s plan asset regulation. Specifically, ERISA section 3(42) redefines “benefit plan investor” to include only

1. ERISA covered employee benefit plans,
2. Tax-qualified retirement plans and accounts (such as KEOGH plans and IRAs) that are subject to the Code’s prohibited transaction rules and
3. Other entities (such as a hedge funds or a feeder fund in a master-feeder structure) whose underlying assets are deemed to be plan assets under the plan asset regulation as modified by ERISA section 3(42) (collectively, ERISA/Code plans).

The significance of the change is in what the term “benefit plan investor” no longer includes. Specifically, prior to the enactment of ERISA section 3(42), the term “benefit plan investor” for purposes of the plan asset regulation included in addition to ERISA/Code plans, retirement plans neither covered by ERISA nor subject to the Code’s prohibited transaction rules, such as governmental, foreign and non-electing church plans. As these non-ERISA/Code plans are no longer

considered benefit plan investors, their investments are no longer aggregated with the investments of the ERISA/Code for purposes of calculating the 25 percent rule, resulting in greater capacity for funds choosing to remain under the 25 percent rule.

The PPA also clarifies that in the context of a fund of funds, master-feeder or other situation where one private investment fund invests in another, the investing fund that holds plan assets only holds plan assets to the extent of its benefit plan investors. Prior to the PPA, it was generally believed to be all or nothing. Thus, an underlying investment fund would generally count 100 percent of the investment by an entity deemed to hold plan assets under the 25 percent rule, regardless of whether benefit plan investors made up 26 percent of the fund's investors or 96 percent. After the PPA, it is clear that the underlying fund, when calculating its 25 percent test, must only consider as plan assets that proportion of an entity's investment, when such entity exceeds the 25 percent rule, attributable to its benefit plan investors. Under the PPA, the extent to which an investor is exposed to benefit plan investors is important to the underlying fund in calculating its benefit plan investor percentage and lines of communications between the underlying and investing funds will have to be established to accurately track such percentages, which could change upon the acquisitions and redemptions of interests in either fund.

As the 25 percent rule is a fairly mechanical test, hedge fund investment managers have historically used feeder funds, clone funds and other structural devices and configurations, such as forced redemptions and conversions of equity interests to debt interests, to "manage" compliance with the 25 percent rule. However, with the enactment of the PPA, the use of these types of structural devices and configurations may to a large extent be unnecessary.

If the Fund is deemed to hold plan assets, the Fund's investment manager will be deemed to be an ERISA fiduciary, subject to ERISA's standard of care and prohibited transaction rules, with respect to each ERISA investor and constitute a fiduciary under the Code's prohibited transaction rules with respect to tax-qualified retirement plans and accounts that are not otherwise subject to ERISA's fiduciary provisions.

Fiduciary Duties and Standards

As an ERISA plan fiduciary, the Fund's investment manager is required to discharge its duties with respect to each ERISA plan investor: (1)

solely in the interest of the plan's participants; (2) for the exclusive purpose of providing benefits to the plan's participants and defraying reasonable plan expenses; (3) with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims (the so-called prudent expert standard); (4) by diversifying investments of the plan assets so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and (5) in accordance with the governing plan documents and instruments, insofar as they are consistent with the provisions of ERISA. Additionally, the Fund is required to maintain the indicia of ownership of all ERISA plan assets within the jurisdiction of the courts of the United States and the investment manager, as a fiduciary, will also have to meet ERISA's bonding requirement.

ERISA fiduciary standards require the investment manager to act prudently and the prohibited transaction provisions, as discussed more fully below, will generally prohibit, absent an applicable exemption, transactions between the Fund and the investment manager (or its affiliates), as well as other third parties who provide services to or otherwise have a relationship with the investing ERISA Plan. In the event of a breach of fiduciary duty, ERISA subjects fiduciaries to *personal liability* for losses and disgorgement of profits earned from such breach. ERISA also voids, as against public policy, certain exculpatory provisions, such as indemnification from plan assets, for losses attributable to breaches of fiduciary duty. Thus, indemnification and standard of care provisions contained in a Fund's offering documents should be drafted with these limits in mind.

Prohibited Transactions

In order to safeguard the financial integrity of retirement assets, ERISA and the Code prohibit, absent an applicable exemption, certain persons, including fiduciaries, service providers, sponsoring employers, unions representing covered employees and certain of their affiliates (referred to as a party-in-interest for purposes of ERISA's provisions or "disqualified persons" for purposes of the Code's provisions), from engaging in certain transactions with the plan. Specifically, a fiduciary is prohibited from knowingly (or where the fiduciary should have known) entering into a transaction with plan assets that constitute a direct or indirect:

(A) sale or exchange, or leasing, of any property between the plan and a party in interest; (B) lending of money or other extension of credit between the plan and a party in interest; (C) furnishing of goods, services or facilities between the plan and a party in interest; (D) transfer to, or use by or for the benefit of, a party in interest, of any asset of the plan; or (E) acquisition, on behalf of the plan, of any employer security or employer real property in violation of ERISA section 407(a).

The prohibited transaction rules further prohibit a fiduciary: (1) from dealing with the assets of the plan in its own interest or for its own account (that is, self-dealing), (2) from in its individual or in any other capacity acting in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries,³ or (3) from receiving any consideration for its own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan (that is, kickbacks).

Violation of the prohibited transaction rules will generally require the unwinding of the transaction (that is, offering recession rights, disgorgement, etc.) and subject the parties involved in the transaction to an excise tax of 15 percent of the amount involved for each year the transaction continues regardless of whether the party in interest knew or should have known that the transaction was prohibited. The Code also imposes an additional 100 percent excise tax if the prohibited transaction remains uncorrected for 90 days after the mailing by the Internal Revenue Service of a notice of deficiency for the initial tax.

ERISA's prohibited transaction provisions are, however, subject to a number of exemptions. These prohibited transaction exemptions take one of three forms: the statutory exemptions contained in ERISA and the Code; Prohibited Transaction Class Exemptions or "PTEs" that are granted by the Department, which can be relied on for any transaction that meets the required conditions; and individual prohibited transaction exemptions that are granted by the Department and can only be relied upon by the party requesting such exemption.

Delegation of Investment Duties

Under ERISA, where an ERISA plan permits it, the authority to manage, acquire, or dispose of plan assets may be delegated by the ERISA plan's named fiduciaries (generally the

plan sponsor or committee thereof) to one or more investment advisers. In such case, if the investment adviser qualifies as an "investment manager" under ERISA (Investment Manager), the trustees of the ERISA plan will not be responsible for the day-to-day management of the plan's assets placed under the control of the Investment Manager, and the trustees generally will not be liable for the actions of the Investment Manager. To qualify as an Investment Manager, the investment adviser must be either: (1) registered as a investment adviser under the Investment Advisers Act of 1940, as amended, or, in certain cases, with one or more state securities authorities, (2) a federally or state supervised bank, or (3) an insurance company qualified to perform investment management services under the laws of more than one state. Also, the investment adviser must acknowledge its fiduciary responsibilities to the plan in writing. If the investment adviser does not qualify as an Investment Manager, the trustee of the investing ERISA plan will retain co-fiduciary responsibility with respect to the acts and omissions of the investment adviser. Conversely, where an Investment Manager is properly appointed, the plan's trustees will not be held responsible for the acts and omissions of the Investment Manager, however, the appointing plan fiduciary will be responsible for the fiduciary decision to appoint the Investment Manager and will remain obligated to monitor such appointment on an on-going basis to ensure that it remains prudent and in the interests of the plan.

As the proper delegation of investment responsibility directly affects the trustees' liability exposure, the documentation of these appointments can be a point of important negotiation from the standpoint of an investing plan. Thus, a detailed discussion of the appointment in the offering documents, specifically drafted to address this issue, may aid a plan fiduciary in deciding to invest in a Fund. In short, plan fiduciaries (and their legal counsel) may view a Fund investment more like the hiring of an investment manager than the purchase of a security and may feel more comfortable in the process if they believe the manager is familiar with ERISA and the regulatory issues that the plan fiduciaries generally operate within.

Specific Issues of Concern When Dealing with Plan Assets

Described below are some of the more common types of transactions for Funds and Fund managers and the issues they raise under the prohibited

transaction rules. The list is by no means intended to be comprehensive.

Transactions Between the Investment Manager (and Its Affiliates) and the Plan

Absent an exemption, almost any transaction between a plan (or its assets) and the Fund's investment manager or other party-in-interest (or any affiliate thereof) is a prohibited transaction. For instance, the borrowing of securities from a person who is a party-in-interest to a plan that invests in a Fund is, absent an exemption, a prohibited transaction. Two commonly used exemptions or exceptions include:

Blind Transactions

The general prohibition against the buying and selling of an asset between a party-in-interest and a plan does not apply to ordinary "blind" securities transactions engaged in through a broker where neither the buyer nor the seller is aware of the identity of the other. The PPA codifies and generally expands this doctrine.⁴ Significantly, the PPA no longer requires the restriction on the knowledge of the identity of the parties. This exemption should cover most exchange transactions. Thus, equity trades done on an exchange or through an electronic communication network (ECN) or alternative trading system (ATS) will not constitute a prohibited transaction if the following conditions are met:

- The cost and compensation associated with the transaction is no greater than that of an arm's length transaction;
- Either (1) the transaction is effected pursuant to rules designed to match purchases and sales at the best price available or (2) neither the execution system nor the parties to the transaction take into account the identity of the parties in the execution of trades;
- If the party in interest has an ownership interest in the execution system, a plan fiduciary, independent of the party in interest, must authorize the transaction; and
- Not less than 30 days prior to the initiation of such transactions, a plan fiduciary is provided written or electronic notice of the use of the trading system.

As this exemption only applies with respect to the purchase or sale, transactions in fixed income securities provide another dimension that this exemption does not cover, that is, the extension of credit between the issuer who may be a party-in-interest and the investing plan. However, when available, the QPAM exemption, discussed next, and/or the new Service Provider exemption added by the PPA may cover both the purchase or sale and the extension of credit.

QPAM Exemption

For transactions that do not fall within the "blind transaction" exception, Funds may try to avail themselves of PTE 84-14 (the so-called QPAM Exemption), which exempts most transactions between a Fund and any person who is a party-in-interest to any plan that invests in the Fund. It is unclear with the new Service Provider exemption, discussed below, if and to what extent Funds will need to rely upon the QPAM exemption in the future. Nevertheless, the QPAM exemption, subject to certain limited exceptions, helps the investment manager avoid prohibited transactions in its dealing, on behalf of the Fund, with a person who is a party-in-interest to a plan invested in the Fund. Where the exemption applies, it does not matter if the investment manager knows that the other party is such a party-in-interest or not. This exemption is extremely important because a large plan can easily have thousands of parties-in-interest, which change all of the time. For example, the investment manager, on behalf of the Fund, may purchase bonds issued by a corporation that provides services to a plan invested in the Fund. Absent the QPAM exemption (or the new Service Provider exemption) and assuming the corporation does not fall into the limited class of parties-in-interest not covered by the exemption, as discussed more fully below, this transaction would constitute a prohibited transaction as an extension of credit between a plan and a party-in-interest and may also constitute a purchase or sale between a plan and a party-in-interest.

To be covered under the QPAM exemption, the transaction must be entered into under the discretionary authority of a "qualified professional asset manager," or "QPAM." The investment manager⁵ will qualify as a QPAM so long as (i) it is a federally registered investment adviser; (ii) it has total client assets under its discretionary management in excess of \$85 million as of the last day of its fiscal year; (iii) it has either shareholders' or partners' equity in excess of \$1 million; and (iv) neither it nor any five percent or more owner

has, within the prior 10 years, been convicted (or released from prison, if later) of a broad range of felonies. The QPAM exemption will cover almost all transactions except:

- Transactions with the QPAM or any of its affiliates;
- Transactions with a party-in-interest (or an affiliate thereof) who has the authority to either appoint or terminate the investment manager as a QPAM with respect to the plan or negotiate the terms of the management agreement with the QPAM (including renewals or modifications thereof) on behalf of the plan;
- Securities lending by the Fund (covered by a separate exemption, see below);
- Acquisitions of interests in mortgage pools (covered by a separate exemption);
- Residential mortgage financing (covered by a separate exemption);
- Transactions involving any ERISA plan when the assets of the plan managed by the QPAM constitute more than 20 percent of the QPAM's total assets under management (not 20 percent of the Fund's assets).

As the excise tax for entering into a prohibited transaction will fall on the party-in-interest that engages in the transaction, reliance on the QPAM exemption is generally key to managing exposure to many types of inadvertent prohibited transactions. Therefore, when QPAM is to be relied on, the investment manager should require, as part of the Fund's offering documents, that each investing plan identify and maintain an up-to-date list of those parties-in-interest for which the QPAM exemption will not be available (that is, those parties-in-interest vested with the authority to hire and terminate the QPAM). For purposes of the QPAM exemption and subject a 10 percent de minimis exception for plans invested in commingled investment funds, the ability to cause a redemption from a Fund managed by the QPAM is deemed the authority to terminate the QPAM.

New Service Provider Exemption

The PPA includes a new Service Provider exemption for a broad array of transactions between a plan and its service providers (other than those

who are fiduciaries with respect to the assets involved in the transaction). Covered transactions include sales or exchanges, leases, and extensions of credit. This exemption is similar to the QPAM exemption, without many of the stringent QPAM conditions as described above. The exemption applies only when the plan receives no less, nor pays no more, than "adequate consideration." Adequate consideration is defined as:

- In the case of a security for which there is a generally recognized market, either (A) the prevailing price on a national securities exchange (taking into account factors such as transaction size and security marketability) or (B) if not traded on a national security exchange, a price not less favorable to the plan (taking into account factors such as transaction size and security marketability) than the offering price for the security as established by current bid and asked prices quoted by persons independent of both the security issuer and the party in interest claiming the exemption, and
- In the case of assets other than a security for which there is a generally recognized market, the fair market value of the asset as determined in good faith by a plan fiduciary in accordance with regulations to be prescribed by the DOL.

As the ultimate determination as to whether or not the adequate consideration requirement is met, especially with respect to off-market transactions, will be a factual issue, delegating fiduciaries and transaction counterparties may feel more comfortable relying on the QPAM exemption. However, as the Department develops regulations as to how to determine fair market value under this exemption, its broad scope may become very useful in providing advisory services with respect to plan assets.

Incentive Fees

Although neither ERISA nor the Code specifically addresses the issue of incentive fees, a fee arrangement pursuant to which a Fund's investment manager (or its affiliate) is compensated based on the investment performance of the Fund may result in a prohibited transaction. To the extent that incentive fees permit the Fund investment manager to control the timing or amount of the incentive fee or otherwise encourages the

manager to make investment decisions that are not in the best interests of the investing plans, in an attempt to maximize its compensation, such fees could result in a non-exempt prohibited transaction.

The Department has issued a number of advisory opinions permitting incentive fee arrangements where the following conditions were present:

- The arrangements complied with Securities and Exchange Commission Rule 205-3 governing incentive compensation arrangements;
- Performance was measured by a formula taking into account both realized and unrealized gains and losses during a pre-established valuation period no shorter than one year;
- A large majority of the investments would be made in securities with readily available market quotations, and those that weren't would be independently valued by persons appointed by the plan and independent of the investment manager;
- Execution of the arrangement was allowed only for plans having aggregate assets of at least \$50 million;
- The arrangement must be approved by an independent fiduciary for each plan involved in the transaction;
- The arrangement must be terminable by a plan "on reasonably short notice under the circumstances;" and
- The total compensation paid to the investment manager will in no case exceed reasonable compensation for services performed.

We are aware that some Funds have gone below the \$50 million threshold in the Advisory Opinions. The key point to emphasize is that the fiduciary approving the investment and fee arrangement must be sophisticated with respect to such issues.

Execution of Securities Transactions

The following four points should be made regarding the execution of securities transactions.

Principal Transactions

In general, if the Fund's investment manager (or an affiliate thereof) engages in a purchase or sale transaction with a Fund acting as a principal, the transaction will constitute a prohibited transaction for which there is no statutory or class exemption available.

Agency Transactions—Reimbursement of Direct Expenses

If the Fund's investment manager directs agency brokerage transactions to itself or an affiliate, a prohibited transaction will generally not occur if the brokerage services are provided on an agency basis for no additional consideration other than reimbursement of direct (out-of-pocket) expenses (for example, costs of unaffiliated clearing brokers).

Affiliated Brokerage—PCE 86-128

The Department issued PTE 86-128 under which an adviser can utilize the services of an affiliated broker and the receipt of brokerage fees from plan accounts for effecting securities transactions will not be prohibited as long as the broker does not engage in "churning." Please note that the underlying investment strategy will be taken into account in determining whether a broker is churning. In addition, the following conditions must be met:

1. Prior and continuing approval of an independent fiduciary is obtained for each plan involved in the transaction.
2. Not less than 30 days prior to implementation of the arrangement or any material change thereto, the independent fiduciary must receive any reasonably available information that the broker/fiduciary seeking authorization believes to be necessary for the independent fiduciary to make an informed approval. Such disclosure must include a description of the broker's "brokerage placement practices." "Brokerage placement practices" refers to policies regarding soft dollars, etc. This requirement can generally be satisfied by providing brokerage placement practice disclosures in the manner required by Form ADV under the Investment Advisers Act.
3. The independent fiduciary's authorization is terminable at will. The affected ERISA Plan must be given a reasonable opportunity to withdraw from a Fund.
4. After trading commences, the independent fiduciary must be provided with respect to each trade of the Fund:

- Confirmation of each trade, or at least once every three months, a summary of all trades;
- A summary report, at least once per year and not more than 45 days after the end of the reporting period, containing:
 - All securities transaction-related charges paid pursuant to PTCE 86-128;
 - A breakdown of charges retained by the fiduciary (and its affiliates) and the charges paid to third parties;
 - A revised description of the broker's placement practices, if they have materially changed; and
 - A portfolio turnover ratio, which is a rough test for churning. For this purpose, PTCE 86-128 prescribes a safe harbor in the form of an "annualized portfolio turnover ratio" calculation.

As PTE 86-128 contains different conditions for pooled investment vehicles that commingle the assets of more than one plan, additional conditions will apply to separately managed accounts and Funds wholly owned by a single plan.

PTE 86-128 also covers, subject to certain additional conditions, agency cross-trades (*i.e.*, transactions in which the same person acts as agent for both seller and buyer for the purchase or sale of a security) where the person (including its affiliates) effecting the trade has discretion (or provides investment advice) with respect to such trade for either the buyer or the seller but not both.

Direct Cross-Trades

The PPA contains a long awaited prohibited transaction exemption for direct cross-trades (that is, when the manager has discretion on both sides of the trade). For purposes of this exemption, cross-trade means the trading of securities between a "large plan" and another account managed by the same adviser who meets the definition of an "investment manager" under ERISA or the Code. As adopted, this exemption is only available for large plans (meaning plans with assets of or part of a master trust with assets of \$100 million or more), thus there remains a number of questions as to how it is to be applied, if at all, to Funds. Moreover, if this exemption is available to Funds, it is also unclear whether the Fund needs to meet the \$100 million limit or if each plan investing therein needs to separately meet the limit. In addition, the following conditions must be met:

1. The transaction is a purchase or sale for no consideration other than cash payment against

- prompt delivery of a security for which market quotations are available;
2. The transaction is effected at the independent current market price of the security;
3. No brokerage commission, fee (except certain customary transfer fees, where certain advance disclosures are made) or other remuneration is paid in connection with the transaction;
4. A plan fiduciary independent of the investment manager authorizes, in advance and in a document separate from any other written agreements of the parties, the ability of the investment manager to conduct such cross-trades;
5. The investment manager provides the plan fiduciary written disclosure, in a separate writing, of the conditions under which cross-trades can occur;
6. The investment manager provides the plan quarterly reports detailing all cross-trades executed in the quarter;
7. The investment manager does not condition its fees on the use of cross-trades or charge a higher fee where the plan fiduciary refuses to permit cross-trades under this exemption;
8. The investment manager has adopted certain written cross-trading policies and procedures⁶ that provide for the allocation of cross-trades among participating accounts in an objective manner; and
9. The investment manager shall designate an individual responsible for periodically reviewing cross-trades to ensure that they were conducted in conformity with the manager's policies and procedures and to certify, under penalty of perjury, to the plan fiduciary, such person's findings and conclusions.

In addition to this new relief, PTE 2002-12 permits, under certain limited circumstances, direct cross-trades that result from certain index/model-driven portfolios (that is, passive cross-trades) or certain large account portfolio restructurings.

Securities Borrowing/Lending

Affiliates. The Fund's investment manager may not lend or borrow Fund securities to or from affiliates.

Lending. The Fund's investment manager may lend Fund securities to unaffiliated persons in two circumstances: (i) the other party is not a party in interest to any ERISA plan that invests in the Fund, or (ii) prohibited transaction class exemption 81-6 applies. The first exception is normally

handled through a combination of due diligence on the part of the investment manager and representations and warranties from the other party. With respect to the representations and warranties, as the QPAM exemption is generally not available for securities lending transactions, it would be appropriate for the manager to obtain from each investing plan a list of known banks and broker-dealers that are parties-in-interest to such plans to ensure that the borrower is not a party-in-interest to such plans. Alternatively, the manager could get a representation for the borrower that it is not such a party-in-interest, but given how broad the term party-in-interest is defined and how consolidated the financial services industry is becoming, borrowers do not provide such a representation easily. Nevertheless, most securities lending arrangements involving plan assets are structured to meet the conditions of PTE 81-6, which permits the lending of plan assets to a party-in-interest where the exemption's conditions are met.

Borrowing. The investment manager, on behalf of the Fund, may generally borrow securities from any person who is not a party-in-interest and may even be able to borrow from a party-in-interest if the QPAM exemption is met.

Investments in Other Funds of the Investment Manager

As the prohibited transaction rules prevent a fiduciary from using its fiduciary authority to hire itself (or an affiliate) to provide an additional service to a plan for an additional fee, the investment of Fund assets by the investment manager into another investment vehicle affiliated with the investment manager is problematic. For example, the investment of cash reserves of the Fund in a mutual fund that is advised by the investment manager (or its affiliates) is a prohibited transaction. However, the Department has promulgated PTE 77-4 for the express purpose of permitting an adviser, where the applicable conditions of the exemption are met, to invest plan assets in the adviser's affiliated mutual fund. It is important to note that PTE 77-4 is only available for investments in open-end investment companies registered under the 1940 Act. For investments in other than mutual funds, there are a number of approaches that may be utilized to address the ERISA and prohibited transaction issues that arise with investments in affiliated funds where PTE 77-4 is not available. Furthermore, it is noted that PTE 77-4 does not relieve the fiduciary of its

basic fiduciary and standard of care with regard to the investment.

Organizational and Operating Expenses

While charging the Fund with organizational and operating expenses for services rendered by unrelated outside service providers affiliated with the investment manager does not generally present a problem, the payment by the Fund of expenses resulting from the engagement of service providers that are affiliated with the investment manager may result in a prohibited transaction. To the extent that the investment manager (or its affiliates are entitled to reimbursement) from a Fund for expenses, the foregoing rules limit such reimbursement to "direct expenses." This generally includes out-of-pocket payments for taxes, insurance, brokerage commissions, fees of outside auditors, etc., but not (i) payment for any item already reasonably included within the scope of the services for which fees are being paid (for example, if the investment manager were to hire a subadviser to assist it, generally it would have to do so at its own expense); or (ii) expenses that are normally includible in overhead (for example, the cost of a new computer terminal dedicated to the Fund) or otherwise fixed (for example, any part of the salary of an existing employee who assists with the Fund). Furthermore, all expenses, regardless of whether they are paid to third-parties or the investment manager (or its affiliate), must also be reasonable in amount and for a service or product that is necessary for the operation of the Fund and the plans invested therein.

Employer Securities

No more than 10 percent of the assets of a defined benefit pension plan may be invested in qualifying securities of the plan's sponsor (including its affiliates). Because many defined benefit plans operate very close to this limit, a Fund's purchase of securities of the plan's sponsor (or affiliates thereof) that is invested in the Fund could cause this 10 percent limit to be exceeded. A procedure should be put in place to ensure that the Fund does not invest (or limits investments) in securities of the sponsors (and their affiliates) of plans invested in the Fund.

Correction Period for Certain Transactions Involving Securities and Commodities

The PPA provides a new mechanism for correcting securities or commodities transactions

that inadvertently violate the non-fiduciary prohibited transaction rules under ERISA or the Code. Specifically, the PPA permits the correction, within a 14-day correction period, of certain securities or commodities transaction. The relief only applies to the non-fiduciary prohibited transaction rules (that is, it does not apply to instances of fiduciary self-dealing, breaches of loyalty or the receipt of kickbacks). Moreover, it neither applies to transactions between a plan and a plan sponsor with respect to the purchase or sale of an employer security or the acquisition, sale or lease of any employer property, nor transactions where the fiduciary or other party in interest knew or reasonably should have known that the transaction would constitute a non-exempt prohibited transaction.

To qualify for this exemption, (1) the transaction must be undone to the extent possible, (2) the plan must be made whole for any losses resulting from the transaction, and (3) profits made by the party in interest through the use of the plan's assets must be restored to the plan. The correction must be completed by the end of the 14-day correction period which starts on the day that the fiduciary either discovers, or reasonably should have discovered, that the transaction would constitute a non-exempt prohibited transaction under ERISA section 406(a) or the corresponding provisions under the Code.

As many of the inadvertent non-fiduciary prohibited transactions covered by this exemption will occur with respect to a party in interest who is a party in interest by virtue of being a service provider (that is, the purchase by a plan of a bond issued by a plan service provider), many of the potential transactions that this provision would have been helpful in addressing prior to the PPA may already be exempt under the Service Providers exemption discussed above. Furthermore, the use of the subjective "should have known" and "should have discovered" standards may cause much uncertainty with respect to relying upon this exemption.

UBTI

As plan trusts are tax exempt for federal income tax purposes they are exposed to potential taxation under the unrelated business taxable income (UBTI) rules of the Code. Thus, certain types of income (such as debt-financed income), when passed through to a tax-exempt investor results in UBTI and requires such investor to file a federal income tax return for such taxable

income and to pay such tax. Although incurring UBTI by a tax-exempt investor is not prohibited by the Code, it does lower investment returns by the applicable tax and many plan trustees try, to the extent possible, to limit or otherwise avoid UBTI entirely as a matter of policy. Thus, when structuring Funds that will target plan investors, recognizing the potential for generating UBTI is a key factor.

Other Considerations

Fund Offering Documents

Unlike securities laws, proper disclosure does not generally prevent or cure a prohibited transaction or breach of fiduciary duty under ERISA or the Code. Accordingly, certain contractual provisions that are generally standard for investment funds that do not hold plan assets may not be permitted or otherwise enforceable for a Fund. The investment manager may not, for example, be able to enforce the following provisions if the Fund's assets are deemed to be plan assets:

- Provisions that require a Fund to pay the legal fees of a general partner of a Fund. Such payment may not be permissible if a suit involves a claim of breach of fiduciary duty on the part of the general partner.
- Provisions permitting certain conflicts of interest. These provisions may violate the investment manager's fiduciary duty to the ERISA plan investors.
- Provisions permitting the investment manager to "bunch" the Fund's orders for the purchase and sale of securities with orders submitted on behalf of other advisory accounts managed by the investment manager. In certain circumstances (for example, always delaying the ERISA plan's trades), this could cause a breach of fiduciary duty.
- Provisions providing the investment manager with significant flexibility in valuing Fund assets. As mentioned, it will be necessary to have valuations of certain assets conducted by independent parties where incentive fee arrangements are utilized.
- Provisions, as mentioned above, purporting to relieve an ERISA fiduciary from its fiduciary responsibilities under ERISA. Accordingly, any indemnity from a Fund to

the Fund's fiduciary for breaches of fiduciary duty will have no legal effect.

Bonding

ERISA fiduciaries must generally be bonded, unless an exception is available. The PPA added a new exemption for registered broker-dealers subject to the fidelity bonding requirements of an SRO (self-regulatory organization). Absent an exception, the amount of the bond is calculated by plan and must be in the amount of at least 10 percent of the amount of ERISA funds "handled," but not more than \$500,000. The PPA also increases the maximum bond amount to \$1,000,000, for plans holding employer securities, effective for plan years after December 31, 2007. It is currently unclear as to how this increase will apply to fiduciaries that either do not handle employer securities at all or handle *de minimums* amounts of employer securities as a manager of a Fund (that is, securities held as part of an S&P 500 fund). Although not required, many plan trustees will also require Fund managers to maintain minimum amounts of errors and omission insurance.

Reporting

Each ERISA Plan must file an annual report with the Department that includes a statement of

all plan assets. If Fund assets include plan assets, then each investing plan's proportionate share of all Fund assets must be reported. As an alternative, the Fund may file a report directly with the Department as a "direct filing entity," reducing the plan's reporting obligation to only reporting its ownership interest in the direct filing entity.

NOTES

1. ERISA section 3(42) was added as part of the Pension Protection Act of 2006, which was signed into law on August 17, 2006.
2. 51 Fed. Reg. 41263.
3. This provision is applicable to ERISA fiduciaries only and is not included in the Code's prohibited transaction rules.
4. At the time of printing, there still remains a number of interpretative issues with this new PPA exemption, which should be addressed by technical corrections. These issues include the exemption's application to national exchanges and situations where the fiduciary placing the trade is affiliated (that is, ownership interest) with the exchange, ECN, ATS or similar system.
5. Different requirements apply for banks, savings and loan associations, and insurance companies.
6. No later than 180 days after the PPA's enactment, the Department, after consultation with the Securities Exchange Commission, is required to issue regulations regarding the content of the policies and procedures to be adopted by the manager.

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