

# THE INVESTMENT LAWYER™

covering legal and regulatory  
issues of asset management

Vol. 13, No. 6 • June 2006

Aspen Publishers

## What to Do If Your Fund Becomes Subject to ERISA

I. Lee Falk and Daniel R. Kleinman

**T**his 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 regulations

of the US Department of Labor (DOL). 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 thus become subject to such provisions by reason of their advisory duties, depending on the composition of the fund’s investors. As the Code contains prohibited transaction provisions that are substantially similar to those of ERISA, for the remainder of this article and unless provided otherwise, references to ERISA’s prohibited transaction rules 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 services, as opposed to an investment in an entity with the purpose of generating profits through its operations. In other words, it 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 that invests in such entity is deemed to hold an undivided interest in its underlying assets, and the managers of the

---

I. Lee Falk is senior counsel in the Employee Benefits and Executive Compensation practice at Morgan Lewis & Bockius, LLP in Philadelphia, PA. Daniel R. Kleinman is an associate in the Investment Management practice at Morgan Lewis & Bockius LLP in Washington, DC. This article is excerpted from the Morgan Lewis Hedge Fund Deskbook. For copies of the Deskbook, please contact Morgan Lewis at [deskbook@morganlewis.com](mailto:deskbook@morganlewis.com).

**ASPEN**  
PUBLISHERS

entity generally will be considered fiduciaries for purposes of applying the prohibited transaction rules and ERISA's fiduciary requirements.

But for two statutory exceptions, ERISA provides no guidance as to what assets are plan assets. First, ERISA § 401(b)(1) provides that when a plan invests in securities issued by investment companies registered under the Investment Company Act of 1940 (Investment Company Act), the assets of the plan include the securities but not the assets of the investment company. Second, ERISA § 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 DOL adopted its "plan asset regulation." As stated in the preamble to the plan asset 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."<sup>1</sup>

As noted, the "plan assets" concept is a look-through rule. The plan asset 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 Investment Company 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 asset regulation, known as VCOCs (venture capital operating companies) or REOCs (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 invest-

tors remains insignificant. In short, the plan asset regulation provides that participation by benefit plan investors is not significant when benefit plan investors own less than 25 percent in value of each class of equity interest in the investment fund (the so-called 25% 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.

To further complicate this calculation, the plan asset regulation defines "benefit plan investor" to include not only ERISA-covered employee benefit plans and other tax-qualified retirement plans and accounts (such as IRAs) that are subject to the Code's prohibited transaction rules, but also employee benefit plans not covered by ERISA, such as governmental, foreign, and church plans. Finally, the term "benefit plan investor" also includes other entities (such as a hedge fund or a feeder fund in a master-feeder structure) whose underlying assets are deemed to be plan assets. Thus, 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% rule.<sup>2</sup>

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 person 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; 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 subsequently, 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 to 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, the 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 dealing with plan assets, including fiduciaries, service providers, and certain of their affiliates (referred to as "parties 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 entering into a transaction with plan assets that the fiduciary knew or should have known would constitute a direct or indirect (1) sale or exchange, or leasing, of any property between the plan and a party in interest; (2) lending of money or other extension of credit between the plan and a party in interest; (3) furnishing of goods, services, or facilities between the plan and a party in interest; (4) transfer to, or use by or for the benefit of, a party in interest, of any asset of the plan; or (5) 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 (*i.e.*, 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 as a representative of a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries,<sup>3</sup> or (3) from receiving any consideration for its own personal account from any party dealing with the plan in connection with a transaction involving the assets of the plan (*i.e.*, kickbacks).

Violation of the prohibited transaction rules will generally require the unwinding of the transaction (*i.e.*, offering rescission 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:

1. The statutory exemptions contained in ERISA and the Code;
2. Prohibited transaction class exemptions, or "PTCEs," that are granted by the Department, which can be relied on for any transaction that meets the required conditions; and
3. Individual prohibited transaction exemptions that are granted by the Department and can only be relied on by the party requesting such exemption.

## Delegation of Investment Duties

When 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, 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 (1) registered as an investment adviser under the Investment Advisers Act of 1940 (Advisers Act), or 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, when 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, as plan fiduciaries they will be responsible for the fiduciary decision to appoint the investment manager and will remain obligated to monitor such appointment on an ongoing basis to ensure that it remains prudent and in the interests of the plan participants.

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 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 among the Investment Manager (and Its Affiliates) and the Plan**

In general, absent an exemption, almost any transaction among a plan (or its assets) and a 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, absent an exemption, is a prohibited transaction. Commonly used exemptions or exceptions are discussed.

#### **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 when neither the buyer nor the seller is aware of the identity of the other. This should cover most exchange transactions. Thus, an equity trade done on an exchange or through an electronic communication network or alternative trading system where the identities of the transacting parties are kept secret should not constitute a prohibited transaction unless the parties know or have reason to know that the plan is entering into a transaction with a party in interest. As the blind transaction doctrine only applies with respect to the purchase or sale, transactions in fixed-income securities provide another dimension as the doctrine does not cover the extension of credit between the issuer who may be a party in interest and the investing plan. However, when available, the QPAM exemption will 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 generally try to avail themselves of PTCE 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. The exemption will, subject to certain limited exceptions, help 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. When the exemption applies, it does not matter whether 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 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 and assuming the corporation does not fall into the limited class of parties in

interest not covered by the exemption, as discussed more fully subsequently, 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 exemption, the transaction must be entered into under the discretionary authority of a “qualified professional asset manager,” or “QPAM.” The investment manager<sup>4</sup> will qualify as a QPAM so long as (1) it is a federally registered investment adviser; (2) it has total client assets under its discretionary management in excess of \$85 million as of the last day of its fiscal year; (3) it has either shareholders’ or partners’ equity in excess of \$1 million; and (4) neither it nor any 5 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); and
- Transactions involving any ERISA plan where 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 the 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 (*i.e.*, 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 authority to terminate the QPAM.

### **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 encourage 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 when the following conditions were present:

- The arrangements complied with SEC 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 preestablished 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 were not 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 had to be approved by an independent fiduciary for each plan involved in the transaction;
- The arrangement was terminable by a plan “on reasonably short notice under the circumstances”; and
- The total compensation paid to the investment manager would in no case exceed reasonable compensation for services performed.

Some funds have gone below the \$50 million threshold set forth 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 three 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 (*e.g.*, costs of unaffiliated clearing brokers).

### Affiliated Brokerage—PTCE 86-128

The Department issued PTCE 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:

- There must be prior and continuing approval of an independent fiduciary for each plan involved in the transaction.
- 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 Advisers Act.

- The independent fiduciary's authorization is terminable at will. The affected ERISA plan must be given a reasonable opportunity to withdraw from a fund.
- 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:
    - i. All securities transaction-related charges paid pursuant to PTCE 86-128.
    - ii. A breakdown of charges retained by the fiduciary (and its affiliates) and the charges paid to third parties.
    - iii. A revised description of the broker's placement practices, if they have materially changed.
    - iv. 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 PTCE 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.

PTCE 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) for which 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.

## 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: (1) when the other party is not a party in interest to any ERISA plan that invests in the fund, or (2) when PTCE 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 from the borrower that it is not such a party in interest, but given how broadly 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 PTCE 81-6, which permits the lending of plan assets to a party in interest when the exemption's conditions are met.

### **Borrowing**

The investment manager, on behalf of the fund, may generally borrow securities from any person that 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 PTCE 77-4 for the express purpose of permitting an adviser, when 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 PTCE 77-4 is only available for investments in open-end investment companies registered under the Investment Company 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 when PTCE 77-4 is not available. Furthermore, it is noted that PTCE 77-4 does not relieve the fiduciary of its

basic fiduciary and standard of care duties 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) is 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 (1) payment for any item already reasonably included within the scope of the services for which fees are being paid (*e.g.*, if the investment manager were to hire a subadviser to assist it, generally it would have to do so at its own expense); or (2) expenses that are normally includable in overhead (*e.g.*, the cost of a new computer terminal dedicated to the fund) or otherwise fixed (*e.g.*, 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.

### **Cross-Trading**

Direct cross-trading (*i.e.*, when the manager has discretion on both sides of the trade) between the fund and other funds of the investment manager or clients is generally prohibited. However, PTCE 2002-12 does permit, under certain limited circumstances, direct cross-trades that result from certain index/model-driven portfolios or certain large account portfolio restructurings. As noted, PTCE 86-128 also permits, when conditions are met, agency cross-trades.

### **Employer Securities**

No more than 10 percent of the assets of a defined benefit pension plan may be invested in 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.

## 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, result in UBTI and require 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 therefore 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 under the 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 the fund to pay the legal fees of a general partner of the 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 (*e.g.*, 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 above, 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 amount of the bond must be at least 10 percent of the amount of ERISA funds handled, but not more than \$500,000. Although it is not mandatory, many plan trustees will also require fund managers to maintain minimum amounts of errors and omissions 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. 51 Fed. Reg. 41263.
2. At the time of printing, there are a number of legislative and regulatory initiatives being pursued to raise the threshold of significance in the benefit plan investor calculation to 50 percent and to otherwise limit and clarify the definition of benefit plan investor and the calculation of significant participation by benefit plan investors.
3. This provision is applicable to ERISA fiduciaries only and is not included in the Code's prohibited transaction rules.
4. Different requirements apply for banks, savings and loan associations, and insurance companies.

Reprinted from *Investment Lawyer*, June 2006, Volume 13 Number 6, pages 3 to 17,  
with permission from Aspen Publishers, Inc., a Wolters Kluwer business, New York, NY,  
1-800-638-8437, [www.aspenpublishers.com](http://www.aspenpublishers.com).