ERISA Plan Investment Vehicles

A Lexis Practice Advisor® Practice Note by Julie K. Stapel, Morgan Lewis & Bockius, LLP

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This practice note discusses common investment vehicles used in employee benefit plans governed by the Employee Retirement Income Security Act of 1974, as amended (ERISA). While there is no list of approved investments for ERISA employee benefit plans, whether they are retirement or welfare benefit plans, this practice note seeks to provide an introduction regarding four different types of common investment vehicles: (1) mutual funds, (2) collective investment trusts, (3) other non-registered private funds, and (4) separately managed accounts.

The practice note is organized to discuss the following topics:

- Introduction to ERISA Investment Vehicles
- Mutual Funds: Legal Structure and Regulation
- Collective Investment Trusts (Pooled Investment Funds): Legal Structure and Regulation
- Other Non-registered Commingled Investment Funds (Hedge Funds and Private Equity Funds): Legal Structure and Regulation
- Separately Managed Accounts: Legal Structure and Regulation
- Summary Chart of ERISA Employee Benefit Plan Investment Vehicles

For related content, see ERISA Fiduciary Compliance for Investment Managers, ERISA Fiduciary Duties, QPAM Exemption Requirements, and Private Equity Fund ERISA Resource Kit.

Introduction to ERISA Investment Vehicles

While ERISA plans (and their plan fiduciaries) employ a variety of legal vehicles to invest the plan's assets, employee benefits practitioners, and even those who may not work with plan investments on a day-to-day basis, are well served by a basic understanding of the most common investment vehicles for ERISA plan investments (primarily for ERISA employee pension benefit plans), namely: mutual funds, collective investment trusts, other non-registered commingled investment funds (e.g., private equity funds), and separately managed accounts.

This is not an exhaustive list of investment vehicles used by ERISA plan fiduciaries who are responsible for investing plan assets. Most notably, the list does not include any insurance vehicles, such as insurance company group annuities, insurance contracts (such as those commonly used to fund health and welfare benefits), or insurance company general accounts. Insurance products are a common feature in certain types of employee benefit plans but would warrant their own practice note given the numerous features and structures. For information on the uses of insurance contracts in ERISA pension plans, see Lexis Tax Advisor — Federal Topical § 1C:12A.01 and Lexis Tax Advisor — Federal Topical § 1C:12A.03.

Before diving into the structures of specific vehicles, keep in mind a few things. First, when analyzing any investment vehicle for an ERISA plan, ERISA Section 403 requires that, with a handful of exceptions primarily relating to assets held by insurance companies, the assets of an employee benefit plan must be held in trust. ERISA § 403(a) (29 U.S.C. § 1103(a)). This is a fundamental requirement of ERISA and reflects one of the chief motivators for the enactment of ERISA nearly five decades ago: the protection of employee benefit plan assets from the creditors of the plan sponsor. So, when we talk about the variety of plan investment vehicles, keep in mind that they must still allow for plan assets to be held in trust.

Second, when we talk about the various regulators that may be involved in any given investment vehicle, remember that the Department of Labor (DOL) and the Internal Revenue Service (IRS) have regulatory authority over ERISA plans generally, including ERISA plan investments. Thus, DOL and IRS are both potential regulators regarding an ERISA plan's investment in any of the vehicles we discuss. Finally, this article is written from the perspective of the investing plan and the counsel who represents the plan in making these investments. Investment service providers may have different perspectives on issues addressed in this article.

The practice note will discuss the legal structure, as well as the applicable regulators, for each of the identified investment types, answering:

- **Who manages the plan assets invested in the vehicle?** In each section, we will discuss who are the investment decision-makers in the vehicle, who selects them, and who negotiates the terms of their services.
- **When the plan invests in the vehicle, where are the plan's assets held?** We will discuss what happens to a plan's assets when it makes an investment in the vehicle. Do the assets leave the plan's trust? If so, where do they go? And what exactly is the plan's asset as it pertains to the investment in the vehicle?
- **What documentation governs the plan's investment in the vehicle?** We will identify the types of documents that you might expect to see when representing a plan investing in that type of vehicle. We will also seek to provide insight on what aspects of the documentation may be negotiable by the plan investor.
- **How does the plan pay the manager of the vehicle?** We will discuss the various structures for the providers of the investment vehicle to be paid. The plan's cost may include more than just payment for the management of the vehicle, and we will discuss those other expenses as well.
- **What are the advantages of the vehicle?** All of the vehicles we discuss in this article are widely used by plan investors so clearly each has features desirable to a plan investor. We will discuss those features and other features that may be more advantageous for certain types of plan investors or under certain circumstances.

Mutual Funds: Legal Structure and Regulation

Mutual funds are a widely used investment structure in ERISA employee benefit plans, especially in participant-directed individual account plans, such as 401(k) plans. A mutual fund, legally and formally known as a "registered investment company," or an "open-end investment company" is governed by the Investment Company Act of 1940. Mutual funds generally take the form of a business trust or corporation under state law. They are governed by boards of directors and are regulated by the Securities and Exchange Commission (SEC). For more information on mutual funds, see Investment Company Classification and Operations in the Lexis Practice Advisor Capital Markets & Corporate Governance practice area.

Who Manages the Plan Assets Invested in the Mutual Fund?

Mutual fund companies employ investment management personnel to manage the mutual fund in accordance with the investment strategy and guidelines set out in the mutual fund's disclosure documents and its organizational documents. The investment management personnel are approved by and monitored by the mutual fund's board of directors.

Plan fiduciaries, frequently a plan investment committee of the plan sponsor, select which mutual funds the ERISA plan will invest in, often in accordance with guidelines for asset allocation set forth in an investment policy statement. In the case of defined contribution plans providing for participant-directed investment, particularly where fiduciaries rely on the relief provided under ERISA Section 404(c), participants will choose among those mutual funds selected by the plan fiduciary for the plan's investment platform, for the investment of their plan contributions and plan account balances.

For background on Section 404(c) protections, see ERISA § 404(c) and QDIA Safe Harbors.

Where Are the Plan's Assets Held When the Plan Invests in Mutual Funds?

The assets of the mutual fund are held in accounts in the name of the mutual fund. Plans purchase shares of the mutual fund through a variety of platforms. The actual purchase by the trust is made from an amount allocated for the purchase of mutual fund interests (such as in a defined benefit plan where individual accounts are not established) or, in defined contribution plans, from assets held in the trust for the benefit of one or more participants. Accounting entries are made to distinguish the amount of the investment that is allocated to any individual participant. In making the purchase, the plan's assets leave the plan's trust, are used to purchase mutual fund shares, and are then held by the mutual fund in the name of the plan's trust.

No Look-Through to Underlying Mutual Fund Assets

Shortly after the enactment of ERISA, the DOL adopted regulations that are referred to as the "plan asset regulations." See 29 C.F.R. § 2510.3-101. The plan asset regulations were part of the DOL's efforts to thwart "end runs" around ERISA in which assets were taken from an ERISA plan and placed in a non-plan entity, where they could not be regulated under ERISA. As a result, the plan asset regulation requires certain pooled investment vehicles to treat their assets as ERISA plan assets by applying a sort of "look-through" rule. While a detailed analysis of the plan asset regulations is beyond the scope of this article, a brief summary appears in the next section.

The plan's assets, once the investment is made, are the mutual fund shares, but the plan's assets do not include any of the underlying assets of the mutual fund. As we will discuss below, this is different than other pooled investment vehicles where, under certain circumstances, the underlying assets of the investment vehicle may be considered the assets of the plan. The consequence of a look-through is the concern that the plan will have a conflict, like a prohibited transaction, because of those underlying investments. Not so for mutual funds which are expressly excluded from any look-through under the plan asset regulation. The underlying assets of a mutual fund are never plan assets. 29 C.F.R. § 2510.3-101(h) (mutual funds are interests sold by investment companies registered under the Investment Company Act of 1940 and so the plan does not hold an undivided interest in the underlying assets of the entity).

Benefit Plan Investors

We pause here to note that the look-through rule refers to participation in the vehicle by "benefit plan investors." The term "benefit plan investor" includes ERISA plans, but also picks up plans, accounts, and arrangements not covered by ERISA but governed by I.R.C. § 4975, as well as entities the assets of which are required to be treated as plan assets because of the operation of the look-through rule. Section 3(42) of ERISA defines benefit plan investor. ERISA § 3(42) (29 U.S.C. § 1002(42)). When discussing the plan asset regulation, we will refer periodically to benefit plan investors. Otherwise, we will stick with ERISA plans, or simply plans, in the rest of the discussion.

For a further discussion of the plan asset rule, especially as it relates to benefit plan investors, see the discussion below in Other Non-registered Commingled Investment Funds (Hedge Funds and Private Equity Funds): Legal Structure and Regulation and see Plan Asset Regulation and the Look-Through Rule under ERISA — Significant Participation Exception (the 25% Test).

What Documentation Governs the Plan's Investment in Mutual Funds?

A plan will likely complete an application to invest in a mutual fund. Mutual funds operate in accordance with their governing documents and in accordance with their public disclosures, such as the prospectus and the fund's statement of additional information. The mutual fund rules impose strict limits against customizing any aspect of the mutual fund for a particular investor. Such customization can only be accomplished through the creation of new classes of shares. Thus, unlike some of the vehicles we will discuss later in this practice note, such as private equity funds, plan investments in mutual funds typically do not involve any negotiation by the investing plan. One exception may be if the plans and the mutual fund company agree to the creation of a new, separate share class. In that case, certain terms, such as fees, may be customized. Mutual funds, which are traded on the stock markets, have annual meetings much as their constituent registrant companies for their publicly traded shares do.

For more information on mutual fund governance, see Securities Law Techniques § 83.07.

How Does the Plan Pay Fees for Its Mutual Fund Investment?

Plans pay mutual fund providers and managers through a variety of fees. These fees are deducted from the assets of the mutual fund. Thus, the holder of the mutual fund share indirectly pays the fee through a reduction in the mutual fund's share value ("net asset value" or NAV). It's not unusual for mutual funds to offer multiple share classes featuring different fees. While the underlying securities are the same among the different share classes, the availability

of a share class, such as an institutional class, to any plan, often is based on the level of plan assets available for investment. For example, an investor class may require the plan's asset base to exceed a dollar amount (e.g., $50 million). Institutional share classes may offer lower fees, including shareholder expenses (like sales loads, redemption fees and purchasing fees) or operating expenses (like management fees, distribution and/or service 12b-1 fees), than are offered under other classes for the mutual fund investment.

It's increasingly common that ERISA plans negotiate with the mutual fund provider to use an institutional class of the mutual fund, those lower fees being passed do to participants. The fee class that a plan fiduciary selects has been a subject of ERISA litigation. See, e.g., Tibble v. Edison Int'l, 2017 U.S. Dist. LEXIS 130806 (C.D. Cal. 2017). Issues raised include whether the fiduciaries exercised due care in selecting mutual funds and, considering all factors, whether they evaluated the appropriate class of mutual funds offered for investment.

Participant Fee Disclosures, Revenue Sharing Payments, and Expense Ratios

The methods by which mutual funds are offered and provided to participant-directed plans can be complex, with multiple parties providing services and receiving fees. Efforts to make mutual fund fees more transparent to both plan sponsors and plan participants was a key objective of the DOL's efforts over the past decade or so to expand the type of disclosures that investment providers must provide. One measure was the plan disclosure regulations under 29 C.F.R. § 2550.404a-5. Those regulations seek to provide plan participants information about the performance of participant-directed investments (over the current, and 1-, 5-, and 10-year periods), and identify fees, as well as identify investment benchmarks and performance. For information on this topic, see Section 404a-5 Rules for Participant Disclosures of Plan Fee and Investment Information. Those disclosures are closely associated with disclosures due to plan fiduciaries by qualified service providers under ERISA Section 408(b)(2). ERISA § 408(b)(2) (29 U.S.C. § 1108(b)(2)). For a further discussion on this topic, see Service Provider Disclosure Rules (ERISA § 408(b)(2)).

Compensation and fee arrangements between mutual fund companies and plan recordkeeping providers has been a focus of ERISA litigation. Mutual fund providers may have related companies provide a platform of the mutual funds for ERISA plan investment. Frequently the related companies provide recordkeeping services. Recordkeepers may be compensated by a mutual fund family for making the mutual funds available on its recordkeeping platform and performing other administrative services in making the funds available. This compensation is often referred to as "revenue sharing." Revenue sharing payments can represent all or a portion of the recordkeeper's compensation for the recordkeeping and administrative services provided to a plan. Neither the DOL nor the courts have taken the position that revenue sharing is impermissible under ERISA, but they have taken the position that fiduciaries must know and understand the degree to which the recordkeeper receives revenue sharing and whether those amounts represent reasonable compensation to the recordkeeper.

For a discussion on revenue sharing, see Expert Interview – Revenue Sharing Issues for Retirement Plan Fiduciaries. Also see Lessons Learned from Recent 401(k) and 403(b) Plan Litigation Settlements.

A plan investor in a mutual fund also bears its pro rata share of the expenses of operating the mutual fund. This amount is generally expressed as an "expense ratio," and includes a wide variety of expenses such as trading, custody, audit, legal, and other organizational and regulatory expenses. The ratio is one of the items required to be disclosed periodically to participants under 29 C.F.R. § 2550.404a-5(d)(1)(iv)(A)(3) (expressed as a dollar amount per $1,000 invested).

What Are the Advantages of Using Mutual Funds in ERISA Plans?

Mutual funds can offer plans a wide array of investment strategies and managers. They allow a plan to have access to strategies, managers, and investments across the risk spectrum, that the plan may not feasibly access on its own in a cost-effective way. This is due to economies of scale. Many tasks of an investment manager can be performed just as efficiently for 1,000 investors as for one investor, allowing the cost to be spread across 1,000 investors rather than just one. Also, some strategies that a plan wishes to employ may simply not be available to the plan if pursued on its own. For example, if a plan wishes to allocate $50 million to an emerging market debt strategy, but it takes $500 million to trade effectively in that strategy, it's advantageous for a plan investor to use the mutual fund vehicle (or a CIT, as discussed below) to invest its $50 million along with other investors seeking the same strategy.

For a participant-directed plan, mutual funds offer accessible, real-time trading. Also, they are quite prevalent in the United States. Plan investors of various sophistication levels have likely heard of them and may have a basic understanding of how to obtain information about

mutual funds, which information should be provided to the participant investors, particularly in plans relying on protections under Section 404(c) of ERISA. See ERISA 404(c)(1) (29 U.S.C. 1104(c)(1), and ERISA § 404(c) and QDIA Safe Harbors.

Collective Investment Trusts (Pooled Investment Funds): Legal Structure and Regulation

Collective investment trusts (CITs) (also known as collective investment funds or CIFs) are a type of tax-exempt pooled investment vehicle that employ the same collective investment of assets as a mutual fund. However, the securities laws do not require CITs to register as mutual funds if certain conditions are satisfied. One of these conditions is that only employee benefit plans and entities are permitted to invest in CITs. Depending on the exact securities law exemption on which the CIT relies, another condition may be that the CIT must be under the ultimate control of a trust company as the legal structure of a CIT is a trust. The specific types of trust can vary. A single CIT may consist of a number of sub-trusts, often referred to as funds, that operate as separate funds with distinct investment strategies.

CITs are regulated by the Office of the Comptroller of the Currency (the OCC), as well as by state regulators of trust companies. To the extent a CIT seeks to be a tax-exempt "group trust" under IRS rules the IRS also regulates the CIT. A CIT that successfully qualifies as a group trust is exempt from federal (and usually state) taxation and enjoys favorable treatment under certain tax treaties with other countries. The group trust rules impose additional requirements on CITs, including that both the CIT and the trust seeking to invest in the CIT (the participating trust) each must contain:

- Specific language that makes the CIT/group trust a part of the participating trust –and–
- Language that restricts the ability of assets of the CIT/group trust or the participating trust to revert back to the plan sponsor

Who Manages the Plan Assets Invested in a CIT?

In some cases, the trustee itself manages the assets of the CIT. Depending on the securities law exemption to be relied upon, the trustee may have to maintain overall discretion or control over the assets of the CIT, even if it has appointed an investment advisor to advise regarding the investment of the CIT overall, or of any specific fund. In that scenario, the appointed investment advisor, who may be either affiliated or unaffiliated with the trustee, may have day-to-day responsibility for managing the CIT or a specific fund. The ultimate authority rests with the trustee. Other CITs are structured to rely on other securities law exemptions, and, in those cases, the investment advisor may have the ultimate authority over the management of the CIT with the trustee acting in a directed capacity.

As with mutual funds, the ERISA plan fiduciary, which often is a committee formed for purposes of overseeing plan investments, selects the CIT(s) in which the plan will invest. CITs have become increasingly common in participant-directed plans, such as 401(k) plans, in which case the plan fiduciaries select the CITs to be included in the plan's investment lineup and then plan participants select investments among the selected investment lineup for the investment of their plan contributions and plan account balances.

Where Are the Plan's Assets Held When an ERISA Plan Invests in a CIT?

When a plan (or a plan participant in a plan providing for participant-directed investments) determines to invest in a CIT, the plan's assets move from the plan trust to the CIT's trust. The assets are then held in the CIT's trust, sometimes directly by the CIT trustee and in other cases by a custodian appointed by the CIT's trustee in the name of the CIT.

The plan's interest in the trust is evidenced by units or interests in the CIT, held in the name of the plan trust. In addition, the plan's assets include an undivided interest in each of the underlying assets of the CIT due to the operation of the "look-through" rule under the plan asset regulation. 29 C.F.R. § 2510.3-101(h)(1)(ii). This contrasts with mutual funds which, as discussed above, are expressly excluded from the look-through provisions of the plan asset regulation. CITs are expressly included in the look-through provisions if there is any amount of investment by a benefit plan investor in the CIT. The plan asset status of the underlying assets also means that those who manage the CIT are fiduciaries within the meaning of ERISA and "disqualified persons" under I.R.C. § 4975 again in contrast with mutual funds. For a definition of "disqualified persons," see Prohibited Transaction and Disqualified Persons Checklist (IRC Rules).

What Documentation Governs the Plan's Investment in a CIT?

The CIT is governed by a declaration of trust. This may include addenda or other supplements to reflect the investment strategies and other terms of the various sub-trusts that the trustee has created. The investing plan will generally be required to complete and agree to an agreement that may be referred to as the adoption agreement or participation agreement.

The degree to which a trustee is willing to vary terms of the declaration of trust depends on the circumstances. Changes to the declaration of trust must apply to all investors in the CIT. Also, the declaration of trust document may have been approved by state regulators such that changes to it must also be approved. Such approval would be another factor in a trustee's willingness to customize terms.

There may, however, be some ability to address specific issues or customized terms through the adoption of a participation agreement or adopting an ancillary agreement such as a side letter of some type. If even greater customization is desired, it may be possible to create an entirely customized CIT for the plan investor (sometimes called a "fund of one"). In that case, the declaration of trust can be fully customized to address that particular plan investor's needs. Of course, a trustee's willingness to offer a fund of one will depend on a number of factors, chief among them is the size of the anticipated plan investment.

How Does the Plan Pay for Its Investment in the CIT?

The CIT trustee typically charges a trust fee and an investment management fee against the assets of the CIT. These fees, along with other expenses of operating the CIT, reduce the assets of the CIT and thus the value of the plan's units or interests in the CIT. CITs are generally able to offer more flexibility on structuring fees than are mutual funds (whose fees are strictly regulated by the Investment Company Act). Plans may choose to structure CIT investments so that investment management fees are paid outside of CIT assets. Like mutual funds, CITs may offer different classes of interests with different features.

The CIT also bears the operational and administrative costs of operating the CIT, including costs of trading, custody, audit, legal, and other organizational or regulatory expenses. These expenses are charged to the trust's assets and thus further reduce the value of the plan's units or interests in the CIT.

What Are the Advantages of the CIT Structure?

One advantage of using CITs is that CITs can generally offer competitive returns. Some ERISA fiduciaries also perceive an advantage to CITs being subject to ERISA's fiduciary and prohibited transaction requirements. This can help align the fiduciary duties applicable to the plan fiduciary choosing the vehicle and the fiduciary duties applicable to those managing the vehicle. Also, the advantages of investing on a commingled basis described in the discussion of mutual funds, above, would apply to CITs as well (i.e., economies of scale, access to strategies requiring large positions).

Other Non-registered Commingled Investment Funds (Hedge Funds and Private Equity Funds): Legal Structure and Regulation

There are non-registered commingled investment funds, that are neither mutual funds nor CITs, in which employee benefit plans may invest. These funds may be referred to as "hedge funds" or "private equity funds," depending on the investment strategy. But those terms lack specific legal meanings and, further, there may be non-registered commingled investment funds with characteristics of both hedge funds and private equity funds. For purposes of this discussion, we will use the term:

- "Hedge funds" to describe private funds with more liquid strategies –and–
- "Private equity funds" to describe private funds that invest in less liquid private company or venture investments

Also, we will interchangeably use the terms "private funds" and "non-registered funds" to refer to this category generally.

What Is the Legal Structure of Non-registered Commingled Investment Funds?

Non-registered funds can take a variety of forms, but limited partnerships or limited liability companies are the most commonly used structures. In the United States, Delaware limited partnerships and Delaware limited liability companies are often used. Non-registered private funds may also be non-U.S. vehicles and, in that case, will generally be a structure under the governing law of that jurisdiction that provides for limited liability of the investors.

The Cayman Islands, for example, is a common offshore home for non-registered private funds.

Non-registered private funds typically offer investments in so-called "private placements," which are not required to register as securities offerings if certain conditions are met. Compared to mutual funds and CITs, non-registered private funds may not be as regulated but are by no means unregulated. The general partner and/or the investment manager of a fund are generally registered investment advisers and are regulated by the SEC in that capacity. In addition, even when offering securities in a private placement, the SEC and state securities regulators still have a role to play to oversee that the private placement requirements are satisfied. In some states, state financial regulators have taken an active interest in the activities of non-registered funds. Offshore funds are subject to regulators in their home jurisdictions as well.

For a discussion on hedge fund organization and investment, see Hedge Funds Structure and Organization and Hedge Fund and Its Offering: Drafting and Reviewing the Key Documentation. For a sample case that analyzes whether the look-through rule requires treating a party to hedge fund as an ERISA fiduciary, see Delphi Beta Fund, LLC v. Univest Bank & Trust Co., 2015 U.S. Dist. LEXIS 39077 (E.D. Pa. 2015).

Who Manages the Plan's Assets Invested in Non-registered Commingled Investment Funds?

Generally, a party affiliated with the sponsor of the non-registered fund will manage the fund. In a limited partnership, the general partner may retain investment management responsibility or delegate investment management responsibility to a separate (though often affiliated) investment manager. The parties who manage the investments are selected by the general partner (or the governing entity of the fund, such as a managing member in the LLC or the directors in certain offshore vehicles).

Plan fiduciaries, including plan investment committees, often assisted by investment consultants, choose which non-registered funds the ERISA plan will invest in. This most often occurs in defined benefit plans as the investment is not often unitized for defined contribution investment (making it easy for individual participants to invest). While there are efforts underway to make private funds more accessible in participant-directed plans, it is not generally the case that participants in employer-sponsored defined contribution plans are able to directly invest in non-registered funds.

Where Are the Plan's Assets Held When the Plan Invests in a Non-registered Commingled Investment Fund?

When investing in a private fund, the plan's assets leave its trust and go to accounts owned by the private fund. In exchange, the plan receives interests or units in the private fund which are generally represented only by the plan's subscription agreement with the fund. The question of what a plan's assets actually are is a complex one for non-registered funds. That question is governed by the "plan asset regulations" under ERISA. See Plan Asset Regulation and the Look-Through Rule under ERISA.

Unless certain other conditions are met, the underlying assets of an entity in which a benefit plan investor, like a retirement plan, invests will constitute assets of that benefit plan investor. This rule applies where 25% or more the equity interests in the entity are owned by the aggregate of all benefit plan investors in the fund. In conducting the 25% calculation, equity interests held by the following are disregarded:

- A person (other than a benefit plan investor) who has discretionary authority or control regarding the assets of the entity
- Any person who provides investment advice for a fee (direct or indirect) with respect to such assets –or–
- Any affiliate of such a person

This means, for example, that if personnel of the general partner or the manager invest in the fund in their personal capacity, those interests are excluded from the denominator of the 25% calculation (which will have the effect of increasing the percentage of assets held by benefit plan investors).

Other ways that a non-registered fund may avoid plan assets are to qualify as a "venture capital operating company" (a VCOC) or a real estate operating company (or REOC). These exceptions are generally only available to private equity, venture-type funds that expect to take active roles in the portfolio companies in which fund invests. Other types of investment strategies, including most pursued by the types of funds commonly referred as hedge funds, will not qualify for VCOC or REOC status. Thus, a fund manager that wishes to avoid ERISA plan asset status, will need to monitor the types of investors coming into a fund and calculate the 25% test at the time of each acquisition or disposition of fund assets. Fund managers perform this monitoring by asking questions in the Fund's subscription agreement regarding plan asset status and by including representations and covenants regarding plan asset status and notice of changes in plan asset status.

If a non-registered fund satisfies one of the exceptions from plan asset status, then the investing plan's asset is the units or interests evidencing the plan's share of the fund. If a non-registered fund does not satisfy one of the exceptions from plan asset status, then the investing plan's asset is not only the units or interests evidencing the plan's share of the fund, but also an undivided interest in the underlying asset of the fund. When a fund's assets are plan assets, the general partner and investment manager of the fund will be ERISA fiduciaries and ERISA's prohibited transaction rules under Section 406, and associated exemptions under Section 408, will apply. See ERISA §§ 406, 408 (29 U.S.C. §§ 1106, 1108). Non-registered funds often have terms or strategies that are inconsistent with ERISA fiduciary status or ERISA's prohibited transaction rules, in which case monitoring the exception from plan asset status is a key obligation of the fund manager.

To learn more about VCOCs and REOCs, see Exception for Venture Capital Operating Companies under the ERISA Plan Assets Regulation.

What Documentation Governs the Plan's Investment in the Non-registered Commingled Investment Fund?

The specifics of the documentation vary with the specific legal entity type. A plan investor can expect, however, to review a disclosure document, typically called a private placement memorandum or offering memorandum. This document bears some similarity to a prospectus in a public offering. In addition, the fund will have a "constitutional" type of organizational document, whether a trust agreement, a limited liability agreement or, in the case of some offshore entities organized as corporations, some type of articles of association. The ERISA plan investor will also be required to complete and agree to a subscription agreement, which will contain questions designed to gather the information that the fund manager needs about the investor as well as additional contractual provisions.

Depending on where a fund is in its fundraising cycle, a plan investor may be able to negotiate changes to the fund's organizational document. A specific investor's comments may also be addressed through a side letter. A non-registered fund generally has more flexibility than a mutual fund, or a CIT, to enter into side letters. A common side letter provision is a so-called most favored nation (or MFN) provision that provides some assurance that no other investor is receiving more favorable terms than the plan investor. MFN provisions are subject to extensive qualifications and carve-outs but can nevertheless be a valuable term that enables a plan investor to "piggyback" to some extent on side letter provisions negotiated by other investors.

For a more comprehensive discussion regarding formation of a hedge fund, see Hedge Fund and Its Offering: Drafting and Reviewing the Key Documentation.

If you represent plans that invest in private funds regularly, you may wish to consider developing a sample side letter or a "hot issues" list to assist in the review of the fund documents and promote consistency across fund investments. For sample side letters, see Benefit Plan Investor Side Letter Agreement (Private Equity Fund Meeting 25% Test) and Benefit Plan Investor Side Letter Agreement (Fund Deemed to Hold Plan Assets).

How Does the ERISA Plan Pay for Its Investment in a Non-Registered Commingled Investment Fund?

The party managing the private fund is generally compensated out of the assets of the fund, meaning that the ERISA plan investor pays that compensation indirectly in the form of a reduction of the NAV of the plan's interest in the fund. There are commonly two forms of compensation in a private fund—a management fee represented by a percentage of the value of the fund's assets and a performance-based fee in which the general partner (or equivalent party in non-partnerships) receives a percentage of the profits of the fund. This is sometimes referred to as a profits interests or a "carried" interest. The calculation of the performance-based fee is often one of the most intricate and complex provisions in the private fund documents. It is also these performance fees that can present the types of concerns under ERISA that motivate many private funds to avoid ERISA plan asset status entirely.

In addition to the compensation paid to the managing entity, an investor in a private fund bears its share of the expenses of the private fund.

What Are the Advantages of the Non-registered Commingled Investment Funds Structure?

Fiduciaries generally view the primary advantage of private funds to be access to managers and strategies not made available through public markets or public offerings. For example, private equity funds may be the only practical avenue a plan has to invest in private companies in their early stages. Hedge funds may be the only way a plan investor can access certain strategies which require a certain concentration of assets to pursue effectively.

Separately Managed Accounts: Legal Structure and Regulation

As compared to the three other types of investment vehicles we have discussed thus far, a separately managed account is the only vehicle where the assets of the plan generally do not leave the plan's trust. Rather, assets are segregated within the trust and assigned to the management of an investment manager. The plan fiduciary gives the investment manager authority to direct the plan's trustee regarding the investment of the assets. While the investment manager may have authority to cause assets to leave the trust, such as to post as margin or collateral, the legal structure of a separately managed account is simply an account designation within the plan's trust.

Investment managers are generally registered investment advisers and are thus regulated by the SEC. Depending on type of trading in question, the investment manager may also be regulated by the Commodity Futures Trading Commission or the National Futures Association.

Who Manages Plan Assets Invested in a Separately Managed Account?

The investment manager hired and appointed to do so manages the assets in the separately managed account. The investment management agreement (IMA) may provide for the appointment of affiliated or unaffiliated sub-advisers. It may also give the investment manager authority to delegate duties to affiliated or unaffiliated third parties. Generally, though, it is expected that the investment manager retains responsibility for the management of the assets. Particularly in a defined benefit plan, the plan investment fiduciaries (like an investment committee) will select one or more investment managers to invest all or a portion of an asset sector in a separately managed account. Separately managed accounts have also been used in defined contribution plans, for example, by creating customized portfolios or funds (sometimes referred to as "white labeling") to include in the plan's investment lineup.

The plan fiduciaries with authority to oversee investments are generally the ones empowered to choose investment managers. From a fiduciary risk management perspective, the appointing fiduciary may wish to confirm that the investment is being appointed as, and accepting appointment as, an "investment manager" within the meaning of Section 3(38) of ERISA. ERISA § 3(38) (29 U.S.C. § 1002(38)). The significance of this appointment is that a properly appointed investment manager can relieve the appointing fiduciary of liability for the actions taken (or omitted) by the investment manager. The appointing fiduciary may retain responsibility for prudently appointing and monitoring the investment manager but should not be liable for the investment manager's decisions. In order to be properly appointed as a Section 3(38) investment manager, the manager must:

- Be a registered investment adviser, bank, or insurance company
- Have the power to manage, acquire, or dispose of plan assets –and–
- Acknowledge in writing that the manager is a fiduciary to the plan

For a discussion of ERISA regulation of investment managers, see ERISA Fiduciary Compliance for Investment Managers.

Where Are the Plan's Assets Held When an ERISA Plan Invests in a Separately Managed Account?

As noted above, assets generally do not leave the trust and the plan is the owner of the investments made by the investment manager in a separately managed account. Trades are carried out in the name of the plan and held in the trust. Depending on the strategies and instruments authorized by the plan fiduciaries who appointed the manager, assets may have to leave the trust to be posted as collateral or margin to support plan trades. Also, to the extent the investment manager has been given authority to invest in mutual funds, CITs, or non-registered funds, assets may leave the trust to be invested in these vehicles.

Further, at the risk of stating the obvious, the assets in the separately managed account are plan assets subject to ERISA as they are assets in the plan's trust.

What Documentation Governs the Plan's Investment in a Separately Managed Account?

Separately managed accounts are generally documented and governed by an IMA between the plan's named fiduciary with responsibility for selecting investment managers. The IMA generally includes investment guidelines that provide specific parameters for the manager's investment mandate. The IMA can be a powerful fiduciary risk management tool for plan fiduciaries as it offers the opportunity to clearly delineate the fiduciary responsibility that has been delegated to the investment manager and the responsibilities of the respective parties. If you frequently represent plans in negotiations with investment managers, you may wish to consider working with the plan

fiduciaries to develop a sample or model IMA to provide investment managers. This can save time relative to having to "retrofit" a manager's form agreement and can provide uniformity across manager relationships.

Because the IMA is a bilateral contract, with no other investor's needs to consider, there can be a substantial amount of negotiation over the terms of an IMA. For a sample IMA, see Investment Management Agreement (ERISA Pension Plan).

How Does an ERISA Plan Pay for Its Investment in a Separately Managed Account?

Separately managed account managers are generally paid an investment management fee expressed as a percentage of assets under the manager's management. The investment management fee can be debited against the trust account and transferred to the manager. IMAs can also use performance fees, but care must be taken to make sure that the performance fee is consistent with ERISA's parameters for performance fees because, unlike a private fund, a separately managed account of an ERISA plan is unavoidably subject to ERISA.

The separately managed account also pays for the trading costs and other expenses that be agreed upon in the IMA that the manager may incur in managing the account.

What Are the Advantages of Using a Separately Managed Account?

One significant advantage to a separately managed account is the ability to customize the services and the management relationship. Another is that the plan investor can pursue its investment strategy without concern for how the trading behavior of other investors will affect it. Also, the documentation and relationship are relatively simple. There are no voluminous fund documents, no complex fund structures.

For Lexis Practice Advisor content regarding investment managers and the use of separately managed accounts, see ERISA Fiduciary Compliance for Investment Managers, Investment Manager Hiring Considerations for ERISA Pension Plans, and QPAM Exemption Requirements.

Summary Chart of ERISA Employee Benefit Plan Investment Vehicles

	Mutual Fund	CIT	Non-registered Fund	Separately Managed Account
Legal Structure	Business trust or corporation	State law trust	Limited partnership, limited liability company, offshore limited liability entities	Plan's trust
Who Manages?	Mutual fund board; mutual fund personnel	CIT trustee and investment manager appointed by CIT trustee	General partner, investment manager, directors of offshore entities	Appointed investment manager
Where Are Assets Held?	In the mutual fund trust (and mutual fund assets are not plan assets)	In the CIT trust (and CIT assets are plan assets)	In accounts of the private fund (and private fund assets may or may not be plan assets)	In the plan's trust
Documentation	Prospectus and other documents; account application	Declaration of Trust, Adoption Agreement	Disclosure document; governing document; subscription agreement; side letter	Investment management agreement
Paying the Manager	Fees and expenses charged against fund assets	Fees and expenses charged against CIT assets	Fees and expenses charged against private fund assets	Asset-based fee charged to separately managed account

For an additional table describing the regulation of various investment vehicles, see Regulation of Investment Companies, "Investment Vehicles Matrix."

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Julie K. Stapel helps employee benefit plan sponsors and financial service providers with the investment, and management of employee benefit plan assets. She advises clients on ERISA fiduciary and prohibited transaction rules, and their impact on investment products and services, and helps those clients use investment documentation and other tools to manage potential fiduciary risks while providing top-quality benefits and services. She also works with plan sponsors and financial service providers to address ERISA–related compliance issues.

Julie helps clients negotiate investment-related agreements of virtually every type, including investment management, trust, securities lending and transition management agreements, as well as many different types of trading agreements. She represents employee benefit plan investors in all types of private fund investments, negotiating fund documentation and side letters to address ERISA and other risk management issues. She also counsels financial services and investment management clients on ERISA compliance.

Co-leader of the firm's Fiduciary Duty Task Force, Julie also advises on fiduciary governance, including the formation and operation of benefit plan fiduciary committees.

She works with plan fiduciaries to implement ERISA compliance best practices and manage fiduciary risks. She also helps clients remain in compliance with ERISA's ever-changing reporting and disclosure obligations.

Julie speaks frequently on ERISA-related topics. She has spoken before the Committee on the Investment of Employee Benefit Assets (CIEBA), the ERISA Industry Committee (ERIC), the John Marshall School of Law, and at various events sponsored by Pension and Investments magazine. In addition to these speaking engagements, she regularly addresses client fiduciary committees and investment staff, performing fiduciary training and presenting updates on changes in the law. She is also president of the Chicago Chapter of Worldwide Employee Benefits Network (WEB).

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