Alternative Investment Quarterly — Third Quarter 2006

Issue 20: Third Quarter 2006

- The quarter past: editorial analysis of recent market developments
- Recently enacted Pension Protection Act will make it easier for hedge fund managers to accept pension investment
- The 'forced' institutionalisation of the hedge funds industry
- A daily dealing fund of hedge funds: Is it a dream?
- Using and interpreting the correlation coefficient in hedge fund of fund comparisons
- How can we protect hedge fund investors?
- Challenges to algorithmic trading in the FX markets
- What to do about commodities

An ISI publication

ISI publications

AIQ ALTERNATIVE INVESTMENT QUARTERLY

Recently enacted Pension Protection Act will make it easier for hedge fund managers to accept pension investment

Michael G. Tannenbaum and J. Michael Roebuck, Tannenbaum Helpern Syracuse & Hirschtritt LLP, New York

The recently enacted Pension Protection Act of 2006 (the PPA) allows hedge funds to accept greater investment from retirement plans without becoming subject to ERISA's fiduciary requirements, while also providing broad relief for common transactions entered into by those funds that are subject to the fiduciary responsibility provisions of ERISA.

The PPA

On 17 August 2006, President Bush signed the PPA, which was passed by the US House of Representatives on 28 July 2006 and by the US Senate on 3 August 2006. The PPA applies to various facets of US pension plans, including funding, the legal standing of cash balance plans and the investment of plan assets. Those provisions of the PPA governing the investment of pension plan assets, especially as relevant to hedge fund managers, are discussed below.

'Plan asset' determinations

The 'plan asset' regulation,[1] promulgated under the Employee Retirement Income Security Act of 1974, as amended (ERISA), sets forth the circumstances under which the assets of an entity in which an employee benefit plan subject to ERISA (an ERISA Plan) invests are treated as including the assets of that ERISA Plan. If the assets of an entity include plan assets, any person having discretionary authority or control over the assets of the entity, or who renders investment advice for a fee to the entity, will be subject to the fiduciary responsibility requirements of ERISA. Among other things, these requirements impose a heightened duty of care, generally prohibit any act of self-dealing by the fiduciary and contain prohibitions on the ability of the fiduciary to engage in transactions with persons or entities having certain relationships to the ERISA Plan whose assets the fiduciary manages or advises.

The plan asset regulation utilises a 'look-through rule' whereby the Department of Labor (the DOL) treats an ERISA Plan as holding an undivided interest in each of the assets of an entity in which it invests unless an exception applies. Hedge funds have historically relied upon the '25% test' exception to the look-through rule, which tests whether investment in the fund by 'benefit plan investors' is 'significant' within the meaning of the plan asset regulation.[2] Under the '25% test', an entity is not treated as holding plan assets and, therefore, not subject to ERISA if 'benefit plan investors' hold less than 25% of each class of equity interests of the entity. For purposes of this determination, equity interests held by any person having discretionary authority or control over the assets of the entity or who renders investment advice for a fee to such entity, as well as affiliates of any such person, are not included.

Prior to the PPA, the plan asset regulation defined a 'benefit plan investor' to include not only ERISA plans, but also certain other plans described in Section 3(3) of ERISA or Section 4975(e)(1) of the US Internal Revenue Code of 1986, as amended (the Code), such as church plans, plans established for governmental employees and non-US employee benefit plans. The PPA generally limits the definition of 'benefit plan investors' to include only those plans subject to ERISA, individual retirement accounts and Keogh plans. Therefore, government plans and non-US plans no longer have to be included in calculating the 25% test.

The PPA continues to include as 'benefit plan investors' those entities deemed to hold plan assets by reason of ERISA Plan investment in the entities. In a significant change from the prior interpretation of the plan asset regulation, the PPA provides that when such an entity invests in another entity (eg, a plan asset fund of funds investing in a portfolio fund), only the *pro rata* portion of the investing entity's assets attributable to ERISA Plans (and those other plans qualifying as benefit plan investors) will count against the underlying entity's 25% test.

The significance of this change is demonstrated by a hypothetical in which an ERISA Plan acquires a 30% interest in a feeder fund which in turns holds a 30% interest in the master fund in which it invests. Assuming that no other ERISA Plan (or other benefit plan investor) holds an interest in either the feeder fund or the master fund, ERISA Plans would hold an effective 9% interest in the master-feeder structure. Prior to the PPA, the assets of both the feeder fund and the master fund would have been considered 'plan assets' subject to ERISA's fiduciary requirements. The introduction of the *pro rata* look-through rule by the PPA results in only the assets of the feeder fund being considered 'plan assets' for purposes of ERISA. This could significantly reduce the manager's ERISA fiduciary responsibilities, in particular if little discretion is exercised at the feeder fund level.

It is unclear how the PPA's *pro rata* look-through rule will be utilised in practice. For example, portfolio funds seeking to satisfy the 25% test will likely request that their 'plan asset entity' investors (eg, funds of funds not satisfying the 25% test) represent the maximum percentage of their equity interests that will be held by benefit plan investors. Such investors will likely seek to be conservative in giving such information, given the difficulties that may exist in predicting the future ERISA status of their investors. However, if 'plan asset entity' investors provide underlying funds with artificially high estimates of their own equity interests held by benefit plan investors, valuable ERISA capacity at the portfolio fund level may go unused.

Service provider exemption

The PPA exempts from ERISA's prohibited transaction rules most transactions between an ERISA Plan and an entity that is a 'party in interest' to the plan solely by reason of providing services to the plan.[3] Prior to the PPA, an ERISA Plan desiring to enter into a transaction with a party in interest to the plan could do so only if an exemption applied. While exemptions exist for most common types of transactions, their applicability is not always certain and their requirements can be cumbersome. The PPA generally exempts such transactions to the extent an involved ERISA Plan pays (or receives) 'adequate consideration' in the transaction. The PPA also clarifies the definition of 'adequate consideration' to provide that: (i) the size of a transaction and marketability of the security can be taken into account whether or not the transaction involves securities for which there is a generally recognised market; and (ii) for securities that are not market-traded, a plan fiduciary can make the determination of fair market value.

This exemption should simplify the documentation of many transactions a plan asset fund commonly enters into, eg, swaps and foreign exchange transactions. Since, in many instances, ERISA Plans and plan asset funds relied upon the QPAM Exemption to enter into such transactions prior to the PPA's effectiveness, the PPA should eliminate most of the disputes over the applicability of, and assumption of risks associated with, the QPAM Exemption.

Other provisions

The PPA contains a variety of pension-related provisions in addition to those noted above. Summaries of the other provisions that will likely impact the operations of hedge funds, their service providers and/or their counterparties follow.

1. Under the Code, a 'disqualified person' (which is in most regards identical to a 'party in interest' under ERISA) engaging in a prohibited transaction is subject to a 15% excise tax on the amount involved in the transaction for each year or part thereof from the time that the transaction is entered into until corrected (with an additional excise tax of 100% of the amount involved in the transaction if the transaction is not corrected after IRS notice). This excise tax can be very severe and greatly exceed both the profits obtained by the disqualified person and the losses accruing to the ERISA Plan in the transaction (indeed, there is no requirement that the ERISA Plan suffer any losses in the transaction).

   The PPA introduces a cure period for prohibited transactions involving the acquisition, holding or disposition of any security or commodity (other than transactions between an ERISA Plan and its sponsor which involve securities or real property of the sponsor). The disqualified person has 14 days to cure the prohibited transaction from the date it discovers, or should discover, the transaction is prohibited. To qualify for this relief, the disqualified person must undo the transaction, make the plan whole for any losses incurred and remit to the plan any profits the disqualified person receives in connection with the transaction. The relief is not available if the disqualified person knew or should have known the transaction was prohibited when entered into or if the transaction is prohibited under Section 406(b) of ERISA (which prohibits certain acts of fiduciary 'self-dealing').

2. The DOL has historically interpreted ERISA as prohibiting a fiduciary from causing an ERISA Plan to enter into (or advising the ERISA Plan with respect to) a transaction with another account managed or advised by the fiduciary. While the DOL has granted several exemptions regarding cross-trades, their scope has been limited and has included many restrictions. Even with these exemptions, the DOL position regarding cross-trades has been more restrictive than other applicable laws, such as the US Investment Advisers Act of 1940.

   The PPA permits such cross-trades if the following criteria are met:

(i) 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 readily available;

(ii) the transaction is effected at the independent current market price of the security within the meaning of Rule 17a-7(b) under the US Investment Company Act of 1940;

(iii) each ERISA Plan involved in the transaction has assets in excess of $100 million;

(iv) the manager establishes written cross-trading policies and procedures that are fair and equitable to all accounts participating in the cross-trading programme, including a description of its methods for pricing and allocating among accounts;

(v) no brokerage commission, fee (other than previously disclosed customary transfer fees) or other remuneration is paid in connection with the transaction by either party to the transaction to the manager;

(vi) an independent fiduciary of the ERISA Plan, after receiving a description of the written policies and procedures of the manager, authorises the cross-trading in advance under a document separate from the investment management agreement;

(vii) the manager does not charge different fees or condition the provision of other services on the independent fiduciary authorising the cross-trading;

(viii) the manager provides a quarterly report to the independent fiduciary including detailed information with respect to each cross-trade executed by the manager on behalf of the ERISA Plan during that quarter; and

(ix) a person designated by the manager conducts an annual written audit regarding the compliance of the cross-trading programme with these

requirements, which must be delivered to the ERISA Plan's independent fiduciary.

3. Because of ERISA's prohibited transaction rules, managers have often been unable to aggregate trades involving ERISA Plans. The PPA provides an exemption from ERISA's prohibited transaction requirements for block trades of at least 10,000 shares or having a market value of at least $200,000. This exemption is not available in respect of any ERISA Plan that constitutes more than 10% of the block trade (eg, an ERISA Plan having more than a 10% interest in a plan asset fund involved in a block trade). Of significance, the PPA does not provide an exemption for block trades in which the counterparty is a fiduciary of any ERISA Plan involved in the trade. This exclusion may limit the usefulness of this exemption

4. Section 412 of ERISA requires that each person 'handling' plan assets be bonded up to $500,000 in respect of each ERISA Plan's assets they handle. The PPA provides an exemption from ERISA's bonding requirement for any broker-dealer registered under Section 15 of the US Securities Exchange Act of 1934 that is subject to the fidelity bond requirement of an exchange or other self-regulatory organisation. In addition, the PPA raises the maximum bonding requirement to $1 million for ERISA Plans which hold employer securities.

5. Several concerns are raised under ERISA in connection with ERISA Plans seeking to use electronic communication networks, alternative trading systems or similar trading systems or venues (each, a 'system'), such as in cases where a fiduciary owns an interest in the system, the impact of transactions which are not 'blind' and the involvement of an owner the system in trades. The PPA provides an exemption for transactions effected on such systems which are subject to regulation or oversight by a federal or foreign regulatory entity if:

   (i) either the transaction matches purchases and sales at the best available price or neither the system nor the parties to the transaction take into account the identity of the parties in the execution of trades;

   (ii) the price of and compensation for the transaction are on an arm's-length basis; and

   (iii) in the event the fiduciary or party in interest engaging in the transaction has an ownership interest in the system, an independent fiduciary of the ERISA Plan authorises the use of the system and at least 30 days' notice is given to the fiduciary before the first transaction.

6. ERISA's prohibited transaction rules prohibit foreign exchange transactions involving the assets of ERISA Plans and parties in interest to such a plan if an exemption is not available. While the DOL has granted two exemptions covering such transactions, the requirements of these exemptions are significant. The PPA would provide broad relief to a bank, broker-dealer or their respective affiliates engaging in a foreign exchange transaction with an ERISA Plan if the following requirements are met:

   (i) the counterparty is not a fiduciary over the ERISA Plan's assets involved in the transaction;

   (ii) the transaction is in connection with the purchase, holding or sale of securities or other investment assets;

   (iii) the transaction is made on terms no less favourable to the ERISA Plan as afforded by the counterparty in comparable, arm's-length transactions; and

   (iv) the exchange rate does not deviate more or less than 3% from the interbank bid and asked rates.

7. The PPA also contains exemptive relief for the provision of investment advice to ERISA Plan participants.

Effective date

Other than the bond requirement change, which becomes effective for plan years beginning after the date of enactment of the PPA, the provisions discussed herein became effective upon the President's signing of the PPA.

Summary

Hedge fund managers and advisers have been, and will continue to be, subject to limitations on the amount of retirement plan assets they may accept without becoming subject to ERISA regulation. The PPA will, however, in many circumstances allow hedge funds to accept additional investment from ERISA Plans, as well as governmental plans and non-US retirement plans, without becoming subject to ERISA's fiduciary requirements. In addition, the PPA contains several provisions that should make it easier to manage, and provide services to or transact with, a plan asset fund in compliance with ERISA's requirements.

Michael G. Tannenbaum and J. Michael Roebuck

Tannenbaum Helpern Syracuse & Hirschtritt LLP, New York

tannenbaum@thshlaw.com

roebuck@thshlaw.com

Tel: 212 508 6700

Endnotes:

1. See 29 CFR Section 2510.3-101.

2. Other exceptions to the look-through rule which are generally not applicable to hedge funds are for 'publicly-offered' securities, registered mutual funds, operating companies and 'venture capital' and 'real estate' operating companies.

3. 'Parties in interest' to an ERISA Plan include, among others, fiduciaries of the plan, service providers to the plan, an employer sponsoring or contributing to the plan, and certain affiliates of the foregoing.