GlobalNote

PRESIDENT SIGNS PENSION LEGISLATION MAKING IT EASIER FOR FUND MANAGERS TO ACCEPT PENSION INVESTMENT[1]

To: **Clients and Friends of Tannenbaum Helpern Syracuse & Hirschtritt LLP**

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I. Introduction

On August 17, 2006, the President signed the Pension Protection Act of 2006 (the "Act"). The Act was passed by the U.S. House of Representatives on July 28, 2006 and by the U.S. Senate on August 3, 2006. A summary of the Act's provisions applicable to the determination of whether an investment fund or other entity is deemed to include "plan assets" for purposes of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), is presented in Section II below. Section III presents a summary of those other provisions of the Act which apply to investment managers and the financial institutions with which they transact.

II. "Plan Asset" Determinations

The "plan asset" regulation[2] promulgated under ERISA sets forth the circumstances under which the U.S. Department of Labor (the "DOL") will treat the assets of an entity in which an employee benefit plan subject to ERISA (an "ERISA Plan") has invested as including the assets of such ERISA Plan. The significance of this treatment is that any

[1] This Memorandum provides general information on the subject matter described, and it should not be relied on for legal advice on any matter, which may turn on specific facts. You should seek specific legal advice before acting with regard to the subjects discussed herein. For further information see the firm's website: www.tannenbaumlaw.com.

[2] See 29 CFR Section 2510.3-101.

such entity becomes subject to the fiduciary responsibility requirements of ERISA and the managers of, and advisors to, the entity become ERISA fiduciaries.

The "plan asset" regulation utilizes a "look-through rule" whereby 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.[3] 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 signing of the Act, the plan asset regulation defined a "benefit plan investor" to include not only ERISA plans, but also certain other plans described in Section 4975(e)(1) of the U.S. Internal Revenue Code of 1986, as amended (the "Code"), such as church plans, plans established for governmental employees and non-U.S. employee benefit plans. The Act 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-U.S. plans no longer have to be included in calculating the 25% test.

The Act 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 Act provides that when such an entity invests in another entity (e.g., 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 counting toward the 25% test) would count against the underlying entity's 25% test. As a result of this change, portfolio funds no longer have to include the full amount of a plan asset fund's investment against their own 25% testing, which should lend to increased capacity for both plan asset funds and ERISA Plans generally.

III. Other Important Provisions

The Act contains a variety of pension-related provisions in addition to the modifications to the 25% test noted above. Following are brief summaries of those other provisions of the Act that may impact the operations of investment managers and advisers.

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[3] 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.

1. The Act 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.[4] Prior to the Act, 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 Act generally exempts such transactions to the extent an involved ERISA Plan pays (or receives) "adequate consideration" in the transaction. The Act 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 recognized 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, e.g., swaps, foreign exchange transactions and securities lending. Since, in many instances, ERISA Plans and plan asset funds relied upon the QPAM Exemption to enter into such transactions prior to the Act's effectiveness, the Act should eliminate most of the disputes over the applicability of, and assumption of risks associated with, the QPAM Exemption.

2. Under the Internal Revenue Code, a "disqualified person" (largely identical to a "party in interest" under ERISA) engaging in a prohibited transaction with an ERISA Plan is subject to a 15% excise tax of the amount involved in the transaction (which increases to 100% if not corrected after IRS notice). The Act introduces a cure period for prohibited transactions involving the acquisition, holding or disposition of any security or commodity (other than securities or real property of the plan sponsor). The disqualified person has fourteen days to cure the prohibited transaction from the date it discovers, or should have discovered, 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.

3. Prior to the Act, ERISA generally prohibited an ERISA Plan fiduciary from causing the plan to enter into 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 have included many restrictions. The Act generally exempts cross-trades if several criteria are met, including a requirement that plans have $100 million in assets and that no brokerage commission or fee (other than previously-disclosed transfer fees) be paid by either party to the transaction.

[4] "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.

4. The Act provides an exemption from ERISA's prohibited transaction requirements for block trades of at least 10,000 shares or $200,000. This exemption is not available in respect of any ERISA Plan that constitutes more than 10% of the block trade (e.g., an ERISA Plan having more than a 10% interest in a plan asset fund involved in a block trade).

5. The Act provides an exemption from ERISA's bonding requirement for any broker-dealer registered under Section 15 of the Exchange Act that is subject to the fidelity bond requirement of an exchange or other self-regulatory organization.

6. The Act also contains exemptions regarding the provision of investment advice to ERISA Plan participants, securities transactions conducted an electronic communication networks and foreign exchange transactions. We can discuss these with you in greater detail if you desire.

IV. Effective Date

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

V. What Does the Act Mean for Advisers?

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 Act will, however, in many circumstances allow hedge funds to accept additional investment from ERISA Plans, as well as governmental plans and non-U.S. retirement plans. In addition, the Act contains several provisions that should make it easier to manage a plan asset fund in compliance with ERISA's requirements.

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If you have any questions or comments regarding the Act, please feel free to contact any of us with whom you have worked in the past or visit our website.