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The Pension Protection Act of 2006 and Its Implications for Investment Funds and ERISA Fiduciaries

On August 17, 2006, the President signed into law the Pension Protection Act of 2006 (the "PPA"), which became effective on August 18, 2006.

Among other things, the PPA will significantly increase the ability of private investment funds to accept investments by pension plans, without causing the assets underlying the fund to be deemed to be "plan assets" for purposes of ERISA and the Internal Revenue Code. In addition to these changes, the PPA also provides:

> prohibited transaction exemption relief with respect to certain transactions;

> a statutory exemption for registered broker-dealers from ERISA bonding requirements and an increase in the maximum bond for plans holding employer securities; and

> a grace period for correction of certain prohibited transactions in order to avoid imposition of excise taxes.

A more detailed discussion of these PPA provisions is set forth below.

Definition of Plan Assets for the Purposes of ERISA

The PPA creates a new defined term under ERISA for "plan assets," which modifies and supersedes the current definition of "plan assets" under the existing regulations by limiting the definition of "benefit plan investor."

The Plan Assets Regulation

In 1986, the DOL promulgated a regulation, 29 C.F.R. Section 2510.3-101 (the "Plan Assets Regulation"), describing what constitutes the assets of a plan with respect to the plan's investment in an entity for purposes of the fiduciary responsibility provisions of Title I of ERISA and Section 4975 of the Code.

Under the Plan Assets Regulation, if a plan invests in an "equity interest" of an entity that is neither a "publicly offered security" nor a security issued by an investment company registered under the Investment Company Act of 1940, the plan's assets are deemed to include both the equity interest itself and an undivided interest in each of the entity's underlying assets, unless it is established that the entity is an "operating company" or that equity participation by "benefit plan investors" is not "significant."

If the assets of a fund were deemed to constitute the assets of an investing plan, (i) transactions involving the assets of the fund could be subject to the fiduciary responsibility and prohibited transaction provisions of ERISA and Section 4975 of the Code, (ii) the fund could be subject to ERISA's reporting and disclosure requirements and

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(iii) the fiduciary causing the plan to make an investment in the fund could be deemed to have improperly delegated its responsibility to manage the assets of the plan.

The Significant Participation Test, Also Known as "the 25 Percent Limitation"

Prior to the enactment of the PPA, the Plan Assets Regulation provided that equity participation in an entity by "benefit plan investors" would be treated as "significant" if, immediately after the most recent transfer, sale or redemption of any equity interest in the entity, twenty-five (25) percent or more of the value of any class of equity interest in the entity were held by benefit plan investors (the "25 Percent Limitation").

For this purpose, the term "benefit plan investor" was defined to include any

> "employee benefit plan" (as defined in Section 3(3) of ERISA), whether or not subject to Title I of ERISA, including, without limitation, governmental plans, foreign pension plans and church plans,

> any "plan" (as defined in Section 4975(e)(1) of the Code), whether or not subject to Section 4975 of the Code, including, without limitation, individual retirement accounts and Keogh plans, and

> any entity whose underlying assets include plan assets by reason of such an employee benefit plan or plan's investment in such entity, including, without limitation, as applicable, an insurance company general account.

In addition, for purposes of making determinations under the 25 Percent Limitation,

— the value of any equity interests held by a person (other than a benefit plan investor) that has discretionary authority or control with respect to the assets of the entity or that provides investment advice for a fee (direct or indirect) with respect to those assets, or any affiliate of such a person (each such person or affiliate, a "Controlling Person"), is disregarded, and

— only the proportion of an insurance company general account's equity investment in the entity that represents plan assets is taken into account.

Definition of Plan Assets under the PPA

> Although the PPA does not raise the 25 Percent Limitation to 50 Percent as earlier versions of the bill had indicated and many had hoped, the PPA adds a definition of "plan assets" as new Section 3(42) of ERISA, which modifies the definition of "plan assets" in the Plan Assets Regulation by:

— defining the term "benefit plan investor" to mean only those plans that are subject to Title I of ERISA or Section 4975 of the Code, and any entity whose underlying assets include plan assets by reason of a plan's investment in such entity (*i.e.*, plans that are not subject to

ERISA or Section 4975 of the Code, such as foreign pension plans, state and local government pension plans and non-electing church plans, will no longer be counted as "benefit plan investors); and

— providing that "an entity shall be considered to hold plan assets only to the extent of the percentage of the equity interest held by benefit plan investors."

The potential impact of these changes can be illustrated through the following examples:

Example 1

Under the Plan Asset Regulation prior the enactment of the PPA, if an investing fund held $24 million of pension plan assets and $76 million of non-pension plan/non-Controlling Person assets, for purposes of testing whether equity participation by benefit plan investors in the recipient investment is significant, the investing fund was treated as a non-"benefit plan investor" investing $100 million of non-pension plan/non-Controlling Person assets. If, however, the investing fund held $30 million of pension plan assets and $70 million of non-pension plan/non-Controlling Person assets, the investing fund was treated for this purpose as a "benefit plan investor" investing $100 million of pension plan assets.

Example 2

Under the PPA, if an investing fund holds $24 million of pension plan assets and $76 million of non-pension plan/non-Controlling Person assets, the investing fund is still treated for this purpose as a non-"benefit plan investor" investing $100 million of non-pension plan/non-Controlling Person assets. If, however, the investing fund holds $30 million of pension plan assets and $70 million of non-pension plan/non-Controlling Person assets, the investing fund is treated for this purpose as a "benefit plan investor" investing $30 million of pension plan assets and a non-pension plan/non-Controlling Person investing $70 million.

Accordingly, any fund that is attempting to utilize the 25 Percent Limitation will now have to monitor the following factors with respect to each of its classes of equity:

> What percentage of the class is held by investors that are subject to Title I of ERISA or Section 4975 of the Code?

> What percentage of the class is held by investors that are funds or other entities all or a portion of the assets of which are "plan assets?"

> To the extent that any class of equity is held by funds or other entities all or a portion of whose assets are "plan assets," what percentage of those funds' assets are attributable to investments by investors that are subject to Title I of ERISA or Section 4975 of the Code?

Moreover, because under the PPA (as was the case under the Plan Assets Regulation) the 25 Percent Limitation must be met each time any equity in the fund is acquired, sold, transferred or redeemed, as of the date of each such transfer the testing entity should either:

- confirm the percentage of "plan assets" held by each investing fund or other entity, or
- require each investing fund or other entity to make a representation regarding the maximum percentage of its assets that will be treated as "plan assets."

This provision is effective with respect to transactions occurring after the date of enactment of the PPA. In the case of closed-end funds with respect to which the last testing date occurred prior to the effective date of the PPA, the enactment of the PPA may not in and of itself change the status of the funds as plan assets unless and until there occurs a new testing date for purposes of the 25 Percent Limitation (*i.e.*, a future transfer, redemption or other disposition of some of the equity issued by the fund). Further clarification may be necessary on this point.

Note that the 25 Percent Limitation is still tested on a "class" by "class" basis; the PPA does not contain any clarification regarding the definition of "class" for this purpose.

Recommendations

In light of these changes, we recommend that funds consider:

- performing a current 25 Percent Limitation calculation based on the changes under the PPA;
- determining whether there is any additional capacity for investments by benefit plan investors;
- reviewing and revising the current offering, subscription or organizational documents (including side letter agreements) that discuss the 25 Percent Limitation to reflect the changes to the 25 Percent Limitation;
- contacting any fund of fund investor regarding whether their calculation for purposes of the 25 Percent Limitation has changed or is expected to change in light of the PPA, and if so, requesting the percentage of such investor that should be treated as plan assets in light of such change; and
- adopting procedures directed at monitoring investment by benefit plan investors whose percentages for purpose of the 25 Percent Limitation may change on an ongoing basis, such as fund of fund investors and insurance company general accounts.

New Prohibited Transaction Exemptions

In addition to the changes described above, the PPA establishes a number of new exemptions from the prohibited transaction rules under Section 406 of ERISA and Section 4975 of the Code for certain types of financial transactions and investments. In many cases, exemptions have been available only under a limited number of existing administrative exemptions, such as the exemption for Qualified Professional Asset Managers. These new rules are, except as otherwise noted, effective with respect to transactions occurring after the date of enactment of the PPA.

Investment Advice

New Section 408(b)(14) of ERISA and new Section 4975(d)(17) of the Code, which are effective for investment advice provided after December 31, 2006, contain an exemption for the provision of investment advice through an "eligible investment advice arrangement" to participants and beneficiaries of a defined contribution plan who direct the investment of their accounts under the plan. If the requirements under the provision are met, the following are exempt from prohibited transaction treatment:

> the provision of investment advice;

> an investment transaction (*i.e.*, a sale, acquisition or holding of a security or other property) pursuant to the advice; and

> the direct or indirect receipt of fees or other compensation in connection with the provision of the advice or an investment transaction pursuant to the advice.

The prohibited transaction exemptions provided under the provision do not in any manner alter existing individual or class exemptions provided by statute or administrative action.

An eligible investment advice arrangement is an arrangement:

> meeting certain requirements (such as audit, notice and disclosure requirements) and

> either

— provides that any fees (including any commission or compensation) received by the fiduciary adviser for investment advice or with respect to an investment transaction with respect to plan assets do not vary depending on the basis of any investment option selected, or

— uses a computer model under an investment advice program that meets certain specified conditions in connection with the provision of investment advice to a participant or beneficiary.

In the case of an eligible investment advice arrangement with respect to a defined contribution plan, the arrangement must be expressly authorized by a plan fiduciary other than (1) the person offering the investment advice program, (2) any person providing investment options under the plan or (3) any affiliate of (1) or (2).

Exemption for Block Trading

New Section 408(b)(15) of ERISA and new Section 4975(d)(18) of the Code contain an exemption for a purchase or sale of securities or other property between a plan and a party in interest (other than a fiduciary) if:

> the transaction involves a block trade;

> at the time of the transaction, the interest of the plan (together with the interests of any other plans maintained by the same plan sponsor) does not exceed 10 percent of the aggregate size of the block trade;

> the terms of the transaction, including the price, are at least as favorable to the plan as an arm's length transaction with an unrelated party; and

> the compensation associated with the transaction is no greater than the compensation associated with an arm's length transaction with an unrelated party.

For purposes of the provision, block trade is defined as any trade of at least 10,000 shares or with a market value of at least $200,000 that will be allocated across two or more unrelated client accounts of a fiduciary.

Exemption for Electronic Communication Network

New Section 408(b)(16) of ERISA and new Section 4975(d)(19) of the Code contain an exemption for a transaction involving the purchase or sale of securities between a plan and a party in interest if:

> the transaction is executed through an electronic communication network, alternative trading system or similar execution system or trading venue that is subject to regulation and oversight by an applicable federal regulating entity or such foreign regulatory entity as may be determined under regulations;

> neither the execution system nor the parties to the transaction take into account the identity of the parties in the execution of trades, or the transaction is effected under rules designed to match purchases and sales at the best price available through the execution system in accordance with applicable rules of the SEC or other relevant governmental authority;

> the price and compensation associated with the purchase and sale are not greater than an arm's length transaction with an unrelated party;

> if the disqualified person has an ownership interest in the system or venue, the system or venue has been authorized by the plan sponsor or other independent fiduciary for this type of transaction; and

> not less than 30 days before the first transaction of this type executed through any such system or venue, a plan fiduciary is provided written notice of the execution of the transaction through the system or venue.

Exemption for Service Providers

New Section 408(b)(17) of ERISA and new Section 4975(d)(20) of the Code contain an exemption for certain transactions (such as sales of property, loans and transfers or use of plan assets) between a plan and a person that is a party in interest solely by reason of providing services (or solely by reason of having certain relationships with a service provider), but only if, in connection with the transaction, the plan receives no less, nor pays more, than adequate consideration. Adequate consideration is defined in the same way as it is defined under Section 3(18) of ERISA, taking into account factors such as the size of the transaction and marketability of the security . The exemption does not apply to a fiduciary (or an affiliate) who has or exercises any discretionary authority or control with respect to the investment of the assets involved in the transaction or who provides investment advice with respect to the assets.
In light of these changes to ERISA and the Code, we recommend that fiduciaries who currently rely on any prohibited transaction exemptions (such as QPAM) consider:

> reviewing whether the changes in the law will allow the fiduciary to enter into additional transactions (*e.g.*, where the investment guidelines restricted certain transactions in order to comply with an existing exemption); and

> reviewing prime broker agreements, ISDAs and other trading documentation for provisions that limited reliance on any current exemption (such as the QPAM Exemption).

Exemption for Foreign Exchange Transactions

New Section 408(b)(18) of ERISA and new Section 4975(d)(21) of the Code contain an exemption for foreign exchange transactions between a bank or broker-dealer (or an affiliate of either) and a plan in connection with the sale, purchase or holding of securities or other investment assets (other than a foreign exchange transaction unrelated to any other investment in securities or other investment assets) if:

> at the time the foreign exchange transaction is entered into, the terms of the transaction are not less favorable to the plan than the terms generally available in comparable arm's length foreign exchange transactions between unrelated parties or the terms afforded by the bank or the broker-dealer (or any affiliate thereof) in comparable arm's-length foreign exchange transactions involving unrelated parties;

> the exchange rate used for a particular foreign exchange transaction may not deviate by more than three percent from the interbank bid and asked rates at the time of the transaction for transactions of comparable size and maturity as displayed on an independent service that reports rates of exchange in the foreign currency market for such currency; and

> the bank, broker-dealer and any affiliate of either does not have investment discretion or provide investment advice with respect to the transaction.

Exemption for Cross Trading

New Section 408(b)(19) of ERISA and new Section 4975(d)(22) of the Code contain an exemption for a transaction involving the purchase and sale of a security between a plan and any other account managed by the same investment manager if certain requirements are met. These requirements are:

> 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;

> the transaction is effected at the independent current market price of the security;

> no brokerage commission fee (except for customary transfer fees, the fact of which is disclosed) or other remuneration is paid in connection with the transaction;

> a fiduciary (other than the investment manager engaging in the cross trades or any affiliate) for each plan participating in the transaction authorizes in advance of any cross-trades (in a document that is separate from any other written agreement of

the parties) the investment manager to engage in cross trades at the investment manager's discretion, after the fiduciary has received disclosure regarding the conditions under which cross trades may take place (but only if the disclosure is separate from any other agreement or disclosure involving the asset management relationship), including the written policies and procedures of the investment manager;

> each plan participating in the transaction has assets of at least $100,000,000, except that, if the assets of a plan are invested in a master trust containing the assets of plans maintained by employers in the same controlled group, the master trust has assets of at least $100,000,000;

> the investment manager provides to the plan fiduciary who has authorized cross trading a quarterly report detailing all cross trades executed by the investment manager in which the plan participated during such quarter, including the following information as applicable: the identity of each security bought or sold, the number of shares or units traded, the parties involved in the cross trade and the trade price and the method used to establish the trade price;

> the investment manager does not base its fee schedule on the plan's consent to cross trading, and no other service (other than the investment opportunities and cost savings available through a cross trade) is conditioned on the plan's consent to cross trading;

> the investment manager has adopted, and cross trades are effected in accordance with, written cross-trading policies and procedures that are fair and equitable to all accounts participating in the cross-trading program and that include a description of the manager's pricing policies and procedures, as well as the manager's policies and procedures for allocating cross trades in an objective manner among accounts participating in the cross-trading program; and

> the investment manager has designated an individual responsible for periodically reviewing purchases and sales to ensure compliance with the written policies and procedures and, following such review, the individual must issue an annual written report no later than 90 days following the period to which it relates, signed under penalty of perjury, to the plan fiduciary who authorized the cross trading, describing the steps performed during the course of the review, the level of compliance, any specific instances of noncompliance and notifying the plan fiduciary of the plan's right to terminate participation in the investment manager's cross-trading program at any time.

In light of these changes to ERISA and the Code, we recommend that investment advisors who currently cross-trade on behalf of non-plan clients but do cross-trade on behalf of client plans that are subject to ERISA or Section 4975 of the Code consider:

> expanding their cross-trading program to include plans with assets of at least $100 million, including adopting or revising the cross-trading program's procedures to permit cross-trading with respect to such plans;

> providing separate written disclosures to independent fiduciaries of plan clients in expanded cross-trading programs.

Prohibited Transaction Correction Grace Period

New Section 408(b)(20) of ERISA and new Section 4975(d)(23) of the Code provide that prohibited transactions entered into in connection with the acquisition, holding or disposition of any security or commodity may be corrected within 14 days of the date the transaction is discovered, or reasonably should have been discovered, by a disqualified person (or other person knowingly participating in the transaction) to be a prohibited transaction. If the correction is made, no excise tax will apply to the transaction.

For this purpose a transaction may be corrected by:

> restoring to the plan or affected account any losses resulting from the transaction and undoing the transaction to the extent possible; and

> returning to the plan or affected account any profits made through the use of the plan assets.

Note that if the prohibited transaction is not corrected within the 14-day period discussed above, the disqualified person will still be liable for the 15 percent excise tax (which increases to 100 percent if the transaction is not corrected), even if the plan suffers no actual harm from the prohibited transaction. In addition, the new exemption does not apply with respect to

> transactions between a plan and its sponsor (or affiliates) that involve the acquisition or sale of employer securities, or the acquisition, sale or lease of employer real property;

> transactions where, at the time the transaction was entered into, the disqualified person (or other person knowingly participating in the transaction) knew, or should have known, that the transaction would constitute a prohibited transaction; and

> transactions involving fiduciary self-dealing or a conflict of interest.

This provision is effective with respect to any transaction that a fiduciary or other person discovers, or reasonably should have discovered, to be a prohibited transaction after the date of enactment of the PPA.

Bonding Requirements

Under ERISA Section 412(a), any plan fiduciary or other person who handles plan assets is required to be covered under a fidelity bond equal to the lesser of $500,000 or 10 percent of the assets handled by such person. For plan years beginning after December 31, 2007, the PPA increases the maximum bond amount to $1 million (from $500,000) for fiduciaries or other persons which handle plan funds or other plan property. In addition, the PPA exempts from these bonding requirements brokers or dealers registered under the Securities Exchange Act of 1934 that are subject to the fidelity bond requirements of a self-regulatory organization.

This provision is effective for plan years beginning after the date of enactment of the PPA.