

ERISA Fundamentals for Fund Managers

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Agenda

- ERISA plan asset investors
- Exceptions to the ERISA plan asset rules
- Heightened compliance concerns for ERISA plan asset funds
- Other important fund related information and considerations

Determining if you Hold Plan Assets – Look-Through Rule

- The United States Department of Labor (Department) has defined when an investment vehicle is deemed to hold “plan assets” for purposes of ERISA in 29 CFR 2510.3-101, as modified by Section 3(42) of ERISA (the Plan Asset Rule)
- The look-through rule applies only to equity investments by a plan
- Every equity investment by a plan in an entity must be looked-through unless an express exception applies

The Exceptions to the ERISA Plan Asset Rule

- Private investment funds in which less than 25% of the value of each class of equity interests in the entity is owned by “benefit plan investors” (the 25% Test)
- “Operating” companies—including “venture capital operating companies” and “real estate operating companies”

Which Entities are Benefit Plan Investors

- Employee benefit plans subject to Title I of ERISA
- Plans or arrangements subject to Section 4975 of the Code, such as IRAs
- Entities whose underlying assets include “plan assets” by reason of a plan’s investment in such entity
 - Fund of funds

Which Entities are Not Benefit Plan Investors

- Section 3(42) of ERISA, enacted as part of the Pension Protection Act of 2006 provided important amendments to the Plan Asset Regulation
- Generally, governmental plans are not subject to ERISA
- Plans maintained outside the US primarily for non-resident aliens
- Church plans which are not subject to ERISA

The 25% Test

- The 25% Test provides that the underlying assets of an entity in which a Benefit Plan Investor has invested will not be considered plan assets under ERISA if the equity participation in the entity by Benefit Plan Investors is “insignificant” (less than 25%)
 - Benefit Plan Investors must hold less than 25% of the value of **each class of equity interests** issued by the fund
 - The 25% Test must be satisfied on an ongoing basis (test upon each transfer, investment and redemption)
 - When calculating the 25% Test, interests held by “controlling persons” must be disregarded

How to Calculate the 25%

- A fund holds \$1,000 of equity and \$240 (24%) of the fund's equity interests are owned by benefit plan investors. No equity is held by controlling persons. A non-benefit plan investor redeems his 10% interest in the fund, leaving \$900 worth of equity in the fund and increasing the percentage of equity interests held by benefit plan investors to 26.67% ($\$900/\240)
 - As of the date of that redemption, the fund became a plan assets fund under the look-through rule because more than 25% of the fund's equity interests are held by benefit plan investors
 - If 25% or more of any class of equity interests in an entity is held by plans, and that entity invests in another entity, only that percentage of plan assets held by the investing entity is used in measuring the interest that constitutes plan assets, not 100% of the investing plan's assets

Operating Company Exception

- Standard Operating Company – an entity that is primarily engaged, directly or through majority owned subsidiaries, in the production or sale of a product or service other than the investment of capital
- Venture Capital Operating Company (VCOC)
 - 50% of the assets of the entity, valued at cost, must be invested in “venture capital investments” or “derivative investments”
 - In the ordinary course of business, the entity must exercise “management rights”
- Real Estate Operating Company (REOC)

Deciding Whether or Not to Hold ERISA Plan Assets

- Pros
 - Accepting ERISA plan investors opens up an additional investor pool
 - Employee benefit plans consist of billions of dollars in assets
- Cons
 - Subject to ERISA's fiduciary rules which can be restrictive
 - Potential for committing fiduciary breaches and/or prohibited transactions under ERISA

Impact of Being a Plan Asset Fund

- Fiduciary duties apply
- ERISA's prohibited transaction rules apply

ERISA Fiduciary Duties

- Section 404 of ERISA imposes a very high standard and a fiduciary must act:
 - solely in the interest of participants and beneficiaries and not act in the fiduciary's proprietary interest (the Duty of Loyalty)
 - with the care, skill, prudence and diligence of a prudent person, expert in such matters (the Duty of Prudence)
 - by diversifying investments so as to avoid the risk of large losses (the Duty of Diversification), and
 - in accordance with the terms of the plan documents (the Duty to Follow the Plan) (can raise authority/capacity questions)
- Reminder: Consequences of fiduciary duty applying is that fiduciary cannot act in own proprietary interest when acting on behalf of a plan and subject to personal liability for losses as a result of a breach of fiduciary duty

Affiliates and Parties-In-Interest

- An Affiliate is either a corporation, partnership, trust, or unincorporated entity in which the party-in-interest is a 10% or more partner, or highly compensated employees of one of these entities where the employer of that employee is the plan sponsor of the ERISA plan
- A party-in-interest includes:
 - plan fiduciaries (including administrators, officers, trustees and custodians), counsel and employees of the plan;
 - persons providing services to a plan;
 - employers or employee organizations whose employees or members are covered by the plan, or their owners with 50% or more interest;
 - corporations, partnerships, trusts and estates of which 50% or more is owned by certain parties in interest;
 - employees, officers, directors or 10% shareholders, partners or joint venture partners of certain parties in interest or of the plan; and
 - certain relatives of parties in interest, including spouses, ancestors, lineal descendants

ERISA's Prohibited Transaction Rules – ERISA §406(a)

- Unless an exemption applies, the transactions prohibited include the:
 - Sale or exchange, or leasing of any property between the plan and a party-in-interest;
 - Lending of money or other extension of credit between the plan and a party-in-interest;
 - Furnishings of goods, services, or facilities between the plan and a party-in-interest;
 - Transfer to, or use by or for the benefit of, a party-in-interest, of any assets of the plan; or
 - Acquisition, on behalf of the plan, of any employer security or employer real property in violation of § 407(a)
- Prohibited Transaction Exemptions are available to exempt the above if you meet the particular conditions, facts and circumstances

ERISA's Prohibited Transaction Rules – ERISA §406(b)

- A fiduciary will not engage in a transaction that involves actual or potential conflicts of interest, such as:
 - Dealing with the assets of a plan in its own interest or for its own account;
 - Acting in any transaction involving the plan on behalf of a party (or represent a party) whose interests are averse to the interests of the:
 - Plan; or
 - Plan participants or beneficiaries; or
 - Receiving consideration for the fiduciary's own personal benefit from any party dealing with the plan in connection with a transaction involving the assets of the plan (“kickbacks”)
- There are no exemptions available

How to Avoid Prohibited Transactions

- There are many exemptions from the prohibited transaction rules
- Available exemptions will depend on investment strategy and types of transactions undertaken by the investment manager

Statutory Exemptions

- ERISA Section 408(b)(2) provides relief for certain **service arrangements** between plans or “plan asset” funds and parties in interest;
- ERISA Section 408(b)(15) for “**block trades**” with parties in interest (trades allocated across two or more client accounts of a fiduciary);
- ERISA § 408(b)(16) permits certain transactions executed using an electronic communication network, **alternative trading system**, or execution system or trading venue that is subject to regulation and oversight by an applicable federal or foreign entity; and
- ERISA Section 408(b)(18) for **foreign exchange transactions** with parties in interest
- ERISA Section 408(b)(17) permits a party-in-interest dealing with the plan (not a fiduciary) to receive compensation for plan transactions, so long as certain conditions are met
- ERISA Section 408(b)(19) for entering into **cross-trades**, i.e., trades between an ERISA account and another account it manages, so long as certain conditions are met

Class Exemptions

- Administrative “class exemptions” issued by the Department also may be useful. These include, among others,
 - PTE 84-14 "Qualified Professional Asset Manager" (QPAM), most comprehensive
 - PTE 86-128 and 408(b)(19), permits a fund adviser to direct fund brokerage to an affiliated broker-dealer (which otherwise would be prohibited), if certain disclosure, approval, and other requirements are satisfied;
 - PTE 75-1 Part II, permits certain “principal” trades of securities between the fund and a party-in-interest that is a broker-dealer registered under the 1934 Act, if certain conditions are satisfied; and
 - PTE 75-1 Part V, permits a broker-dealer registered under the 1934 Act that is a party-in-interest to extend credit to the fund (e.g., margin, short sales) if certain conditions are met

Other Important Fund-related Information and Considerations

- Related BPI Investors: Prohibited Transactions and Conflicts of Interest
- IRA Investments: Members/Partners of the General Partner
- IRA Platforms: Helping Investors use their IRAs
- Reporting Issues: Form 5500 and ERISA 408(b)(2)
- Representations: Side Letter Requests
- Certificates: Initial and Annual Certificates
- Alternative Investment Vehicles: A second look at the Plan Asset Rule met

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