FINANCIAL SERVICES AND PRODUCTS ADVISORY

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Landmark Pension Reform Act Expands Ability of Investment Funds to Accept Benefit Plan Investments

Last week the U.S. Senate passed comprehensive pension reform legislation that will have wide-ranging impact on the structure and operation of hedge funds and other investment vehicles. The new Pension Protection Act of 2006 ("PPA 2006") makes significant changes to the existing ERISA "plan asset" rules and expands the opportunities for investment funds to qualify for an exception from ERISA plan asset treatment. These changes will enable certain fund managers to increase the amount of benefit plan assets under management without becoming subject to ERISA fiduciary obligations and prohibited transaction rules.

In particular, PPA 2006 changes the method of counting benefit plan investors in determining whether a fund satisfies the 25% "significant equity participation" test under ERISA. The 25% test generally provides that a fund's underlying assets will not be considered to be ERISA plan assets (*i.e.*, ERISA will not "look through" to the underlying assets of the fund) if "benefit plan investors" own less than 25% of the value of each class of equity interests in the fund. Historically, the "benefit plan investor" group included not only ERISA benefit plans and IRAs but also benefit plans not subject to ERISA, such as foreign plans, government plans and church plans. Of key importance under PPA 2006 is that such foreign plans, government plans and church plans are no longer counted in determining whether the 25% threshold has been exceeded. By eliminating such foreign plans, governmental plans and church plans from the numerator of the 25% test, funds will have the potential to increase the amount of benefit plan assets of all types under management without exceeding the 25% limitation.

PPA 2006 also includes important clarifications for counting benefit plan investors in the fund of funds context. In the past, there was some uncertainty as to how the 25% test should be calculated by an underlying fund (the "recipient fund") when a fund of funds (the "investing fund") that itself exceeded the 25% test invested in the recipient fund. For example, if 40% of the investing fund's equity was owned by benefit plan investors (thereby subjecting the investing fund to ERISA), the question was whether the investing fund's equity interest in the recipient fund should be considered by the recipient fund as being owned entirely by benefit plan investors (an all-or-nothing approach). Instead of the all-or-nothing approach, PPA 2006 adopts a proportional approach under which the recipient fund will be considered to hold benefit plan assets only to the extent of the percentage of its equity interests held by benefit plan investors in the investing fund (*i.e.*, only 40% of the assets invested by the investing fund in the example above will be considered as coming from benefit plan investors).

It should be noted that some other important changes that were raised or formally proposed during the lengthy legislative process were not ultimately adopted as part of PPA 2006. Specifically, the proposal to increase the 25% threshold to 50% did not make its way into the new law. In addition, Congress also left intact the current rules under which the 25% test is calculated with regard to each separate "class" of equity interest in a fund, rather than with regard to all of a fund's equity as a whole. The definition of "class" of equity for these purposes still remains unclear after PPA 2006.

Although this liberalization of the plan asset rules was not as significant as had been proposed, these changes represent a significant expansion of the exception from plan asset treatment.

The new legislation is effective with respect to transactions occurring after the date of enactment, which is expected to occur when the President signs it into law later this month.

Bearing in mind the ability of funds to attract additional benefit plan investors, we recommend that the following steps be taken:

- Assess current levels of equity held by benefit plan investors in relation to the 25% test as amended by PPA 2006.
- Consider whether the asset raising objectives of a fund should be modified to take account of the new rules and to permit additional benefit plan investors, and if so, what practical changes must be made to the fund's operation so that it calculates and tracks benefit plan investors under the new rules.
- Determine the form and content of disclosure to existing fund investors regarding any changes to be made to reflect PPA 2006; consider necessary requests for additional information (e.g., current benefit plan investor status under the new law).
- Review and revise disclosure in offering memoranda to reflect the rules relating to the 25% test.
- Review and revise fund subscription agreements to reflect the new definition of "benefit plan investors" and, in the case of a fund of funds, the new proportional test.

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