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Applying ERISA's Plan Asset Regulation

by S. John Ryan, Seward & Kissel LLP

S. John Ryan is a partner in the New York office of Seward & Kissel LLP. Assistance provided by associate Frank Mitchell of Seward & Kissel's New York office.

In 1987, the U.S. Department of Labor (DOL) promulgated a regulation defining the term "plan assets" in specific situations. 29 C.F.R. § 2510.3-101 (the Plan Asset Regulation). The purpose of the Plan Asset Regulation is to impose fiduciary obligations under the Employee Retirement Income Security Act of 1974 (ERISA) in situations where an ERISA plan investor (plan), although nominally investing its assets in a separate entity, is, as a practical matter, retaining the persons who manage the separate entity to provide investment management services to the plan.

The Plan Asset Regulation describes the circumstances when the assets of the separate entity are deemed to be "plan assets" of the plan (i.e., the look-through rule). This practice note will address those circumstances and provide guidance on each major exception to the Plan Asset Regulation's look-through rule, including the

- Publicly Offered Securities Exception
- Operating Companies Exception, and
- Significant Participation Exception (Also Known as the 25% Test)

The Look-Through Rule and Equity Interests

The look-through rule is only applicable to "equity interests." The Plan Asset Regulation defines an equity interest as "any interest in an entity other than an instrument that is treated as indebtedness under applicable local law and which has no substantial equity features." 29 C.F.R. § 2510.3-101(b)(1). Generally, the right to participate in the profits of an entity is a "substantial equity feature." Examples of an equity interest include a profits interest in a partnership, an undivided ownership interest in property, and a beneficial interest in a trust. As the DOL explained in Advisory Opinion 96-23A, available at http://www.dol.gov/ebsa/programs/ori/advisory96/96-23a.htm, even if an entity holds only debt securities, the interest in the entity can be an equity interest, subjecting the entity and its manager to the fiduciary rules of ERISA.

Hedge funds and private equity funds that issue common shares or limited partnership interests are clearly issuing equity interests. For certain securities, however, the determination can be less clear. Issuers of collateralized loan obligations (CLOs), for example, often treat their more junior classes of notes as equity for purposes of the Plan Asset Regulation, even though these notes may be treated as debt for federal income tax purposes and frequently receive ratings (non-investment grade) from nationally recognized ratings agencies. To avoid the application, or the possible application, of ERISA to the pool and its manager, issuers often place restrictions on purchases of the junior tranches by benefit plan investors. Additionally, debt issued by certain trusts or non-U.S. partnerships may be characterized as equity or having substantial equity features, and the issuer may place limitations or outright prohibitions on their purchase by benefit plan investors. When representing benefit plan investors, you should review the offering materials of such an investment to determine whether this type of "issuer restriction" is present.

Exceptions to the Look-Through Rule

The Plan Asset Regulation provides exceptions to the "look-through rule" by providing that investment in an equity interest does not give a plan an interest in the separate entity's underlying assets in the following instances:

- The equity interest is a publicly offered security or a security issued by an investment company registered under the Investment Company Act of 1940.
- The issuer is an "operating company."
- Benefit plan investors do not significantly participate in the equity ownership of the separate entity (also known as the 25% Test).

29 C.F.R. § 2510.3-101(a)(2).

Publicly Offered Securities Exception

The look-through imposed by the Plan Asset Regulation is not applicable to plan investments in "publicly-offered securities." A "publicly-offered security" is one that is

- "freely transferrable,"
- "widely-held," and
- either (1) part of a class of securities registered under Section 12(b) or 12(g) of the Securities Exchange Act of 1934 or (2) sold to the plan as part of an offering to the public pursuant to a registration statement under the Securities Act of 1933 that will be registered under the Securities Exchange Act of 1934 within 120 days of the end of the fiscal year of the issuer in which the offering took place.

29 C.F.R. § 2510.3-101(b)(2).

A class of securities is "widely-held" if it is owned by 100 or more investors independent of the issuer and of one another. 29 C.F.R. § 2510.3-101(b)(3). Whether a class of securities is "freely transferrable" is a factual question that is determined on the basis of all relevant facts and circumstances. 29 C.F.R. § 2510.3-101(b)(4). For securities that have a minimum investment of $10,000 or less, the Plan Asset Regulation provides that certain transfer restrictions, such as minimum transfer amounts or prohibitions against transfers to ineligible investors, will not ordinarily affect the "freely transferrable" determination. Id.

As provided in Section 401(b)(1) of ERISA (29 U.S.C. § 1101(b)(1)), the Plan Asset Regulation reiterates that a plan's investment in an investment company that is registered under the Investment Company Act of 1940 (i.e., a mutual fund) does not subject the assets of the registered investment company to ERISA.

Operating Companies Exception

The look-through imposed by the Plan Asset Regulation is not applicable to a plan's investment in an "operating company." An operating company is

- an entity that is primarily engaged, directly or through a majority-owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital,
- a "venture capital operating company" (VCOC), or
- a "real estate operating company" (REOC).

29 C.F.R. § 2510.3-101(c).

Except with respect to VCOCs and REOCs, there is little bright-line guidance on what type of entity qualifies as an operating company. The Plan Asset Regulation's preamble merely states that whether an entity is an operating company is a "factual question to be resolved taking into account the particular characteristics of the entity under consideration." See Final Regulation Relating to the Definition of Plan Assets, 51 Fed. Reg. 41262 (Nov. 13, 1986). In practice, the determination is typically very straightforward, unless you are examining an entity that carries on both operating company and investment fund activities, such as those involved in aircraft leasing, ship leasing, and oil and gas ventures. In the absence of specific guidance from the DOL, this determination can vary from practitioner to practitioner.

Due to the technical complexities of the VCOC and REOC tests, VCOCs and REOCs usually obtain opinions of counsel for the benefit of ERISA plan investors that the entity's first long-term investment is a qualifying venture capital investment or real estate capital investment, respectively (as described in more detail below). VCOCs and REOCs also typically provide plan investors with annual certificates regarding VCOC and REOC status thereafter.

Venture Capital Operating Companies (VCOCs)

To be a VCOC, an entity must meet

- an "Asset Test" on its "Initial Valuation Date" and on at least one day during its "Annual Valuation Period" and
- an ongoing "Management Test."

29 C.F.R. § 2510.3-101(d).

Asset Test

On the Initial Valuation Date and on at least one day during subsequent Annual Valuation Periods, at least 50% of the entity's assets, valued at cost, must be invested in operating companies as to which the entity has or obtains "management rights" ("venture capital investments"). For purposes of the Asset Test, a venture capital investment can be a REOC but cannot be another VCOC. Neither the Plan Asset Regulation nor the DOL has provided any guidance on how "valued at cost" is determined. Any reasonable determination of cost, so long as it is uniformly applied over the life and assets of the VCOC, should be acceptable.

The VCOC's interest in a venture capital investment does not need to be equity—debt securities are sufficient provided the investment has the requisite management rights. A VCOC may also count "derivative investments" toward its Asset Test. A derivative investment is an investment that previously qualified as a venture capital investment but with respect to which the VCOC's management rights were extinguished in a corporate transaction related to a public offering, merger, or reorganization. A derivative investment will continue to qualify as a venture capital investment until the later of 10 years from the original investment or 2½ years from the date on which it became a derivative investment.

VCOCs may be tiered structures whereby the operating company is held by a wholly-owned subsidiary of the VCOC. See Advisory Opinion 95-04A, available at http://www.dol.gov/ebsa/programs/ori/advisory95/95-04a.htm. When determining whether a subsidiary is wholly owned, a VCOC may disregard de minimis interests held by a general partner of a limited partnership as well as interests held by certain governmental investors for regulatory purposes. Id.

The DOL took the position in Advisory Opinion 96-26A, available at http://www.dol.gov/ebsa/programs/ori/advisory96/96-26a.htm, that an entity that does not meet the Asset Test when it makes its first long-term investment can never qualify as a VCOC. It is therefore crucial that an entity that intends to rely on the VCOC exception be certain that its initial investment is a qualifying investment.

<u>Initial Valuation Date</u>

The Initial Valuation Date is the date an investment fund makes its first investment that is not a short-term investment pending long-term commitment. 29 C.F.R. § 2510.3-101(d)(5)(i). In DOL Advisory Opinion 89-15A, the DOL held that, prior to the Initial Valuation Date, an entity cannot qualify as a VCOC. However, in an information letter issued to Carol Buckmann dated September 23, 1998, available at http://www.dol.gov/ebsa/programs/ori/advisory98/buckmann.htm, the DOL clarified that "to the extent that employee benefit plan funds are transferred to a venture capital company on the initial valuation date solely for the purpose of the acquisition of an equity interest in a qualifying venture capital investment[,] such funds would not constitute plan assets on that date." This letter established the so-called "one-day rule" permitting venture capital companies to draw down capital and make their first investments on the same day without becoming ERISA fiduciaries.

If a venture capital company wishes to call capital prior to the day of its first long-term investment, it would be deemed to hold plan assets if benefit plan investors hold more than 25% of the outstanding capital commitments of the fund (assuming the fund has a single class of equity interests). For a manager that does not wish to act as an ERISA fiduciary during a fund's start-up period, the VCOC can typically address this issue in one of two ways: (1) it can limit the drawdown of benefit plan investors' commitments to less than 25% of total drawn capital or (2) it can require benefit plan investors to make their capital contributions to an escrow account, which is released upon the fund's first long-term investment(s). In DOL Advisory Opinion 95-04A, available at http://www.dol.gov/ebsa/programs/ori/advisory95/95-04a.htm, the DOL stated that where funds are contributed to an escrow account by a plan in anticipation of acquisition of an equity interest in an entity, the acquisition of the equity interest would not occur until the escrow is released and therefore plans hold no interest in the fund until that time.

Annual Valuation Period

The Annual Valuation Period is an annual period of time predetermined by the VCOC. It must not exceed 90 days and must begin no later than the anniversary of the Initial Valuation Date. 29 C.F.R. § 2510.3-101(d)(5)(ii). Once established, the Annual Valuation Period cannot be changed except for good cause unrelated to the VCOC determination. Id. This rule prohibits an entity from shifting its Annual Valuation Period to cherry-pick the periods that it satisfies the Asset Test.

Management Rights

"Management rights" are defined by the Plan Asset Regulation as "contractual rights directly between the investor and an operating company to substantially participate in, or substantially influence the conduct of, the management of the operating company." 29 C.F.R. § 2510.3-101(d)(3)(ii). Whether a VCOC has obtained sufficient management rights to make an investment a "good" venture capital investment is an inherently factual question that must be determined by taking into account all facts and circumstances. The DOL has provided the following guidance in this regard:

- The DOL stated in Advisory Opinion 2002-01A, available at http://www.dol.gov/ebsa/regs/aos/ao2002-01a.html, that to acquire management rights, "the investor must acquire rights . . . that are more significant than those normally negotiated by investors with respect to investments in established, credit worthy companies" and concluded that the certain rights of an investing fund to receive financial statements and other information from the company, to inspect the books and records of a company, and to consult with management of the company on all matters relating to the portfolio company's operation were sufficient to constitute such management rights.

- In DOL Advisory Opinion 95-04A, available at http://www.dol.gov/ebsa/programs/ori/advisory95/95-04a.htm, the DOL stated that "management rights do not require that a VCOC have the power to direct a portfolio company's management to comply with the VCOC's input, or that any contract providing for management rights require that the VCOC receive compensation for performing management activities. For example, if [a VCOC] appointed one director to a three (or more) person board the [DOL] would find the requirement that a VCOC obtain management rights satisfied. Similarly, . . . VCOC managers who 'routinely consult informally with' or 'advise' management [are] illustrative of the type of management rights contemplated by the [Plan Asset Regulation]. Accordingly, there appears to be a range of management rights that [a VCOC] may exercise with respect to its portfolio companies that would be consistent with the [DOL Plan Asset Regulation]." Advisory Opinion 95-04A also noted that direct contractual rights do not necessarily require a separate contract between a VCOC and an operating company if the VCOC is named in a wholly-owned subsidiary's investment contract and given the requisite management rights in that contract.

- The preamble to the Plan Asset Regulation also provides that management rights cannot be "shared" with other co-investors; they must be exercisable unilaterally by the VCOC (though multiple investors may each have their own management rights). Rights that are embedded in the security (e.g., sufficient holding to elect a director or to be on a debtor's committee) are not management rights for purposes of the VCOC test. See Final Regulation Relating to the Definition of Plan Assets, 51 Fed. Reg. 41262 (Nov. 13, 1986).

Management Test

Once the VCOC has satisfied the Asset Test, the VCOC must be able to demonstrate that, during the period that starts on the Initial Valuation Date and ending on the last day of the first Annual Valuation Period, and then during each subsequent 12-month period, the VCOC has, in the ordinary course of its business, actually exercised its management rights with respect to one or more of the operating companies in which it invests and has devoted substantial resources to doing so.

Distribution Period

A VCOC that is in its "distribution period" (i.e., winding down) no longer needs to meet the Asset Test or the Management Test in order to remain a VCOC. The distribution period begins on any date selected by the VCOC following distribution to investors of at least 50% of the highest amount of investments made by the VCOC (on a cost basis). 29 C.F.R. § 2510.3-101(d)(2)(ii). The distribution period ends 10 years from the date on which it begins or on the date that the VCOC makes a new portfolio investment, whichever is earlier. Id.

Real Estate Operating Companies (REOCs)

To be a REOC, an entity must meet (1) an "Asset Test" on its "Initial Valuation Date" and on at least one day during its "Annual Valuation Period" and (2) a "Management Test" during each 12-month period that ends on the last day of the Annual Valuation Periods. 29 C.F.R. § 2510.3-101(e). These tests are substantially similar to the tests for VCOCs.

Asset Test

On the Initial Valuation Date and on at least one day during the subsequent Annual Valuation Periods, at least 50% of the entity's assets must be invested in real estate that is managed or developed and with respect to which such entity has the right to substantially participate directly in the management or development activities.

In performing the Asset Test, you should consider the following points:

- Examples in the Plan Asset Regulation provide that a fund is not engaged in the management or development of real estate merely because it assumes the risks of ownership of income-producing real property. Specifically, the examples provide that an investment in property subject to long-term leases under which substantially all management and maintenance activities are the responsibility of the lessee (triple-net leases) would not qualify towards satisfaction of the Asset Test. 29 C.F.R. § 2510.3-101(j)(7).

- The examples provide that management and development activities may be performed through independent contractors working under the supervision and authority of the REOC. 29 C.F.R. § 2510.3-101(j)(8).

- Although Advisory Opinion 95-04A, available at http://www.dol.gov/ebsa/programs/ori/advisory95/95-04a.htm, did not specifically discuss tiered REOC structures (which historically led some practitioners to question whether they were permitted), we believe that the reasoning for tiered VCOCs is equally applicable to REOCs. Additionally, an example in the Plan Asset Regulation specifically describes a tiered arrangement in which a developer and REOC form a limited partnership to hold property. 29 C.F.R. § 2510.3-101(j)(9).

- The same example provides that a REOC may hold qualifying real estate investments through debt or equity, and such investment may be made directly or through subsidiaries that do not need to be wholly owned by the REOC. Id.

Though there is no direct guidance on the matter, you should assume that, as with the VCOC exception, an entity that does not meet its Asset Test when it makes its first long-term investment can never qualify as a REOC.

Initial Valuation Date

The Initial Valuation Date is the same as for a VCOC. Though there is no direct guidance on the matter, you should assume that, like the VCOC exception, a fund cannot qualify as a REOC until its Initial Valuation Date, and if it does not qualify as a REOC on its Initial Valuation Date, it can never qualify as a REOC.

Annual Valuation Period

The Annual Valuation Period is the same as for a VCOC.

Management Test

Once the Asset Test has been satisfied, the fund must be able to demonstrate that, during the period that starts on the Initial Valuation Date and ending on the last day of the Annual Valuation Period, and then during each subsequent 12-month period, the fund has actually engaged directly in real estate management or development activities.

Distribution Period

There is no relief from the Asset Test or Management Test for REOCs during any wind-down period. (Note that the Plan Asset Regulation does not directly address this issue.)

Significant Participation Exception (Also Known as the 25% Test)

The final exception to the Plan Asset Regulation's look-through rule is the significant participation safe harbor, also known as the 25% Test. 29 C.F.R. § 2510.3-101(f). In drafting the Plan Asset Regulation, the DOL concluded that if "benefit plan investors" hold less than 25% of the equity interests of a separate entity, it is unlikely that the entity specifically solicited plan investors or that plan investors had an expectation that the entity would be managed in furtherance of their particular investment objectives. The significant participation safe harbor provides that, unless one of the exceptions detailed above applies, an entity's assets will be deemed to be "plan assets" for purposes of ERISA and Section 4975 of the Code (26 U.S.C. § 4975) if

- "benefit plan investors" hold 25% or more of any class of equity interests of the entity, ***excluding*** investments held by persons that exercise discretionary control over the entity's assets or that provide investment advice for a fee to the entity, or their affiliates (the "25% Test").

29 C.F.R. § 2510.3-101(f)(1).

The following fraction illustrates the application of the 25% Test:

Total value of class held by ERISA-covered pension plans, IRAs, and other "benefit plan investors"

Total value of entire class, less the value of shares held by the investment manager, its affiliates, and employees (other than investments by an ERISA-covered retirement plan of the investment manager or its affiliates, or an IRA of their employees or principals)

During any period when the 25% threshold is equaled or exceeded, the assets of the entity are deemed to be assets of each investing plan and IRA, and the manager of the separate entity is a fiduciary to each investing plan and IRA subject to the fiduciary responsibility and prohibited transaction provisions of ERISA and Section 4975 of the Code (26 U.S.C. § 4975). The significant participation test applies upon any acquisition, redemption, or transfer of an equity interest in an entity, so an entity can fluctuate between holding plan assets and not holding plan assets. Upon crossing the 25% threshold, a fund is a plan asset entity; there is no remedial or "grace" period, and it will only cease to be a plan asset entity upon going below the 25% threshold again.

Benefit Plan Investors

The term "benefit plan investor" is defined in Section 3(42) of ERISA (29 U.S.C. § 1002(42)) and means

- any employee benefit plan that is subject to Title I of ERISA (e.g., U.S. corporate pension plans and Taft-Hartley plans, 401(k) plans, etc.);

- any plan not described above but described in, and subject to, Section 4975 of the Code (26 U.S.C. § 4975) (e.g., individual retirement accounts (IRAs), Keogh plans, and other retirement plans that are solely for the benefit of business owners and their spouses); and

- any entity whose underlying assets include plan assets by reason of a plan's investment in the entity (e.g., a fund-of-funds that that has more than 25% of a class of its equity interests owned by "benefit plan investors"; group trusts that are tax-exempt under Section 501(a) of the Code (26 U.S.C. § 501(a)) pursuant to the principles of Revenue Ruling 81-100; common or collective trust funds of banks; and certain investments by insurance companies).

Governmental, church, and non-U.S. plans are not "benefit plan investors," although until the passage of the Pension Protection Act of 2006, 109 P.L. 280, 611, 120 Stat. 780, 972 (Aug. 17, 2006), the definition included these plans.

Subscription agreements for investment funds require investors to make representations regarding their benefit plan investor status. If an investor is an entity whose underlying assets include plan assets, these representations generally require the investor to provide the percentage of its assets that are plan assets and to notify the fund in advance of any increase of its plan asset percentage.

Entity-Level Testing

The Plan Asset Regulation does not define the term "entity." Based upon the structure of the Plan Asset Regulation and the preamble thereto, you should interpret the term "entity" to mean any legal structure creating a separate legal entity. Additionally, any investment structure through which an investor's return is based solely on separately identifiable property is treated as the sole property of a separate entity (a so-called "hypothetical entity"). 29 C.F.R. § 2510.3-101(g). Based on the mechanical nature of the 25% Test, you should conduct the 25% Test for each entity and independently determine each entity's ERISA characterization.

Master-Feeder Fund Structures

A master-feeder fund structure is one in which one or more top-level funds are organized to address various tax and regulatory concerns of investors ("feeder funds"). Investors access the fund structure through an investment in a feeder fund, and the feeder funds invest in a lower-level vehicle (the "master fund") that generally makes all investments. In a typical master-feeder fund structure, if a feeder fund is below the 25% threshold, its manager is not an ERISA fiduciary and, when the feeder fund invests in the master fund, the feeder fund's investment is not made by a benefit plan investor and is only included in the denominator of the master fund's calculation. If the feeder fund does exceed the 25% threshold, its manager would be an ERISA fiduciary and, when it invests in the master fund, a proportional share of the feeder fund's investment (equal to the percentage of the equity interests held by benefit plan investors in the feeder fund as compared to the overall value of the feeder fund) would be considered to be held by a benefit plan investor and, therefore, would count toward that master fund's 25% Test. The master fund's 25% Test is then calculated using the percentages of benefit plan investor participation of the over 25% feeder funds.

Hardwired Feeder Funds

Since the enactment of the Pension Protection Act, it has become increasingly common for hedge funds to organize "hardwired feeder funds." In a variant of a master-feeder fund structure, the hardwired feeder fund is required to invest all its assets into the master fund. The hardwired feeder fund is permitted to cross its 25% threshold, but the master fund restricts benefit plan investor participation to maintain its non-ERISA status. Because the proportionality rule—i.e., the Pension Protection Act's rule that a benefit plan investor that is a separate entity shall be considered to hold plan assets only to the extent of the percentage of the equity interest held by benefit plan investors—is not applied on a class-by-class basis, this structure allows a manager to maximize the amount of benefit plan investors without subjecting its investment activities to ERISA.

There is a split among practitioners as to whether the investment manager of the hardwired feeder fund is an ERISA fiduciary. One camp holds that, because the investment manager does not exercise any authority or control over the management of plan assets, the manager is not a fiduciary as defined in Section 3(21) of ERISA (29 U.S.C. §§ 1002(21)); the other camp holds that the investment manager retains some residual authority or control over the management of plan assets, but because a person is only a fiduciary "to the extent" of such authority or control, the investment manager's fiduciary responsibility is extremely limited. It is universally accepted that the investment activities undertaken at the master fund are not subject to ERISA.

Applying the Hypothetical Entity Test

If the value of a plan's equity interest relates solely to identified property of an entity, such property is considered to be the sole property of a separate "hypothetical" entity. This "hypothetical entity" test is relevant for hedge fund managers that have the ability to segregate a particular fund investment as a "side pocket" because only investors that hold equity in the fund on the day the side pocket is designated will participate in that side pocket. It is also relevant to entities that provide investors the option of exposure to separate portfolios of investments (Delaware Series LLCs and Cayman Islands Segregate Portfolio Companies, for example).

To determine benefit plan investor participation in a hypothetical entity, all equity participants in the designated investment or portfolio should be treated as if they had invested in the designated investment or portfolio directly. Funds that allow investors to elect whether or not to participate in side pockets may find that, although the fund itself has not crossed the 25% threshold, electing investors make up more than 25% of a particular side pocket. In this instance, a fund manager will typically reserve the right to cause non–pro rata participation to avoid that side-pocket investment from becoming a plan asset. This is important where a side-pocket incentive fee or allocation is taken upon realization of the side pocket investment, which, if the side pocket were subject to ERISA, would raise fiduciary duty concerns. For entities with separate portfolios, the plan asset status of one portfolio could affect the plan asset status of other portfolios.

Class-by-Class Basis of the Test

Under the Plan Asset Regulation, each class of equity interest must be tested separately. However, the term "class," as used in the 25% Test, is not defined by the Plan Asset Regulation. As a general rule, if a fund specifically designates its equity interests as separate classes (i.e., an offshore fund issues class A and class B shares), the nomenclature should control. Where the fund does not designate separate classes or where there are series within a class with distinctive features, determining whether separate classes exist is less straightforward.

Defining "Class:" Two Perspectives

Generally practitioners fall into two camps when addressing the definition of a "class." One camp looks to the rule cited in paragraph (b) of the Plan Asset Regulation (29 C.F.R. § 2510.3-101(b)) distinguishing between debt and equity interest, and determines class under "applicable local law." However, under this approach two securities with identical features could be characterized differently for ERISA purposes depending on the jurisdiction under which the fund was created.

The other camp looks to the rule also cited in paragraph (b) of the Plan Asset Regulation (29 C.F.R. § 2510.3-101(b)) that defines the term "publicly-offered securities" as a "part of a class of securities under Section 12(b) or 12(g) of the Securities and Exchange Act of 1934." Section 12(g) treats securities with substantially similar characteristics that provide their holders with substantially similar rights and privileges as constituting a single class. In addition, the Securities and Exchange Commission has issued several "no-action" letters that addressed the characterization of separate classes of equity securities of the same issuer, as such term is used in Section 12(g). In analyzing whether common stock, warrants, or partnership interests of a single issuer constitute two separate "classes of equity" for purposes of Section 12(g), the staff of the SEC has focused on the following characteristics, rights, and privileges: (1) differences in the allocation of profits and losses, (2) differences in voting rights, (3) differences in priority upon liquidation, and (4) differences regarding distributions.

Best Approaches for Determining "Class of Equity Interest"

It appears more logical to apply U.S. law and the SEC's guidance to determine "class of equity interest" under the Plan Asset Regulation; doing so avoids the curious situation where identical securities would be treated differently under the Plan Asset Regulation solely by reason of the country in which the fund was formed. Based upon Section 12 of the Securities and Exchange Act of 1934 and several SEC "no-action" letters issued in connection with Section 12, shares having different rights and privileges with respect to the allocation of profits or losses, voting, and priority upon liquidation should be treated as different classes under the Plan Asset Regulation. We also believe you should treat shares issued in different currencies, regardless of whether the foreign currency exposure is hedged, as different classes of equity interests. In our view, you should consider differences in management fees and redemption features to have substantially similar characteristics and provide the holders with substantially similar rights and privileges, and, therefore, be considered a single class of equity interests for the purposes of the Plan Asset Regulation.

Note that, because the test is performed on a class-by-class basis, it is possible for an entity to be deemed to hold plan assets even where overall plan investment is relatively small. For example, suppose an entity issues class A and class B shares, and has $995 invested in class A, none of which is attributable to a benefit plan investor, and $5 invested in class B, all of which is attributable to a benefit plan investor. Despite the fact that benefit plan investors hold only one-half of 1% (0.5%) of the fund's equity, the fund is deemed to hold plan assets because 100% of class B is held by benefit plan investors.

Exclusion of Certain Investments

When performing the 25% Test, you must exclude investments "held by" persons (other than benefit plan investors) (1) with discretionary authority or control over the assets of the entity, (2) who provide investment advice for a fee with respect to such assets, or (3) who are an affiliate of such a person (collectively, "control persons"). An affiliate is defined to include a person or entity, directly or indirectly controlling, controlled by or under common control with the fund's manager. In the preamble to the Plan Asset Regulation, the DOL concluded that it was necessary "to disregard investments by [an] entity's managers and their affiliates for purposes of applying the test . . . [because] without these restrictions the test could be easily manipulated so as to avoid a determination that plan investment is significant." See Final Regulation Relating to the Definition of Plan Assets, 51 Fed. Reg. 41262 (Nov. 13, 1986).

Generally, determining who is a control person is straightforward: you exclude the investment manager's investment or carried interest, and you exclude personal, non-plan/non-IRA investments by the investment manager's owners and employees. However, in situations where an investment fund invests in another fund managed by the same investment manager or where a trust established for the benefit of a member of the fund's investment manager makes the investment, questions can arise in applying the test because the Plan Asset Regulation does not define what "held by" means.

Debate Concerning the Definition of "Held by" in Connection with Feeder Funds

In the case of a feeder fund that is generally designed to invest in a specified master fund, the feeder fund is essentially acting in the role of custodian holding its investment in the master fund for the feeder fund's investors. It is well-established practice within the investment fund industry, and clearly known to be so by the DOL, for an investment manager (or two or more entities under common control) to be the investment manager of both the feeder funds and the master fund in these types of master-feeder fund arrangements. If the term "held by" were to include these types of "custodial" arrangements, the result would be to invalidate any master-feeder arrangement that has a feeder fund subject to the "plan asset" rules, since all non-"plan asset" funds would be disregarded as "held by" a controlling person. Furthermore, to void such arrangements would seem contrary to the intent of the proportionality feature of Section 3(42) of ERISA (29 U.S.C. § 1002(42)), which provides that a benefit plan investor is considered to hold plan assets only to the extent of the percentage of its equity interests held by benefit plan investors. To reshape the 25% Test to require proportionality on the one hand and then to disallow the non–benefit plan investor proportion of an investment under the controlling person exclusion provisions of the 25% Test would be inconsistent with this provision.

While most practitioners agree that "held by" does not refer to the custodial arrangements described in the preceding paragraph, there is still disagreement as to what "held by" means. The overwhelming majority of practitioners subscribe to one of two interpretations: (1) being beneficially owned or (2) having investment control.

<u>Interpretation of "Held by" in Connection with Feeder Funds</u>

For the following reasons, we subscribe to the former interpretation that "held by" means being beneficially owned.

The preamble to the Plan Asset Regulation specifically refers to "the exclusion of the value of equity interests owned by the entity manager (or its affiliates) in calculating whether there is significant plan investment in an entity." See Final Regulation Relating to the Definition of Plan Assets, 51 Fed. Reg. 41262 (Nov. 13, 1986) (Emphasis added.) Example 4 of Section (j) of the Plan Asset Regulation (29 C.F.R. § 2510.3-101(j)) also refers to interests owned by an affiliate of the investment manager in demonstrating the mechanics of which investments are disregarded when calculating the 25% Test. Further, an investment fund is the client of the manager and, as a contractual matter and under securities law, the manager owes a duty to its client to manage the fund's assets in the best interests of the fund. As a common law fiduciary to the fund, a manager that makes an investment in a corporation or partnership for the purpose of avoiding the application of the fiduciary responsibility provisions of ERISA to itself would be in contravention of these duties.

As the DOL noted in footnote 42 to the preamble to the Plan Asset Regulation, "the Department would consider a fiduciary who makes or retains an investment in a corporation or partnership for the purpose of avoiding the application of the fiduciary responsibility provisions of [ERISA] to be in contravention of the provisions of [S]ection 404(a) of [ERISA] [9 U.S.C.S. § 1104(a)]." See Final Regulation Relating to the Definition of Plan Assets, 51 Fed. Reg. 41262 (Nov. 13, 1986). Breaching one's fiduciary duties to a fund's investors does not appear to be the easy manipulation cited by the DOL as the basis of the restriction. While we do not think that mere investment discretion provides an opportunity for easy manipulation, practitioners that interpret "held by" to mean "having investment control" believe that even non-proprietary assets (a managed fund, for example) that the manager has discretion over need to be excluded from the 25% Test generally on the basis that such manipulation is possible.

An investment manager investing funds it beneficially owns is not restricted by the same general or ERISA fiduciary law concerns and could use its own beneficially owned funds however it likes, including for no purpose other than to avoid unfavorable results under the 25% Test for one of its managed funds, the exact situation (i.e., easy manipulation) the DOL was trying to avoid. Thus, the purpose behind the DOL's excluding funds "held by" an investment manager seems to apply to funds beneficially owned by an investment manager because of the lack of legal constraints that otherwise apply in the case of a fund managed (but not beneficially owned) by the investment manager. Therefore, under this approach, investments of assets beneficially owned by a control person must be backed out of both the feeder fund's 25% Test and the master fund's 25% Test.

Acquisition of an Equity Interest

The Plan Asset Regulation mandates that you perform the 25% Test upon each "acquisition" of an equity interest in an applicable entity but does not define "acquisition." 29 C.F.R. § 2510.3-101(f)(1). The DOL held in Advisory Opinion 89-05A that it considers a withdrawal of an interest in a partnership to be an "acquisition" for purposes of the 25% Test because the withdrawal would result in an increase in the ownership percentages of the remaining partners. In the same Advisory Opinion, the DOL stated that it would also consider an intra-family transfer, including those effected through devise or inheritance, to be acquisitions. Note that because withdrawals and transfers are considered "acquisitions," it is possible that a withdrawal by a non–benefit plan investor or transfer made between two non–benefit plan investors could cause a fund to cross the 25% threshold if an existing investor (such as a fund-of-funds) has, since the last acquisition, become a benefit plan investor or where an existing benefit plan investor has experienced an increase in its plan asset percentage.

IRA-Only Funds

Due to the differences between Title I of ERISA (that applies to employee benefit plans) and the prohibited transaction rules of Section 4975 of the Code (26 U.S.C. § 4975) (that applies to IRAs), there is a misconception that, when performing the 25% Test, "IRAs don't matter" (or at least they do not matter until you accept investments from an employee benefit plan subject to ERISA). In practice, if an entity crosses the Plan Asset Regulation's 25% threshold and does so only due to investments by benefit plan investors that are subject to Section 4975), the entity is still deemed to hold "plan assets." However, the assets are only subject to Section 4975 (i.e., the prohibited transaction rules) and not the broader fiduciary responsibility provisions of Title I of ERISA (e.g., a prudent expert standard of care and potential personal liability).

Entities That Are Always Deemed to Hold Plan Assets

Certain specialized entities are always considered to hold plan assets under the Plan Asset Regulation when an ERISA-covered plan invests, regardless of the entity's underlying "benefit plan investor" participation. These are:

- Group trusts that are exempt from taxation under Section 501(a) of the Code (26 U.S.C. § 501(a)) pursuant to Revenue Ruling 81-100, 1981-1 C.B. 326
- A common or collective trust fund of a bank
- Certain insurance company separate accounts
- Any entity in which a plan or related group of plans owns all of the entity's equity interests.

29 C.F.R. § 2510.3-101(h).

It is unclear if the proportionality rule of the Pension Protection Act applies to these entities. However, given that these entities are typically close to or at 100% benefit plan investor participation, the benefit of proportionality would likely be minimal and we believe you should count such entities as 100% when counting them in the 25% Test.

Main Considerations in Addressing Plan Asset Regulation Issues

On the surface, the Plan Asset Regulation provides a relatively straightforward set of rules for determining whether an entity is subject to ERISA. You first need to determine if you are dealing with equity interests. If you are, you look to see if the entity is an operating company or mutual fund or if the equity is publicly traded. If not, you perform the 25% Test. In the preamble to the Plan Asset Regulation, the DOL stated that the 25% Test "was intended to provide a mechanical test which would permit entity managers and investing plans to more easily analyze the consequences under the [Plan Asset Regulation] where characterization of the investment under other provisions of the [Plan Asset Regulation] (such as the operating company exception) is unclear." See Final Regulation Relating to the Definition of Plan Assets, 51 Fed. Reg. 41262 (Nov. 13, 1986).

While the framework of the Plan Asset Regulation and the 25% Test is certainly straightforward, as you can see from the issues outlined in this practice note, the devil is in the details. Foot faults in making determinations under the Plan Asset Regulation are easy to come by and difficult to spot. Because managing plan assets in compliance with ERISA fiduciary duties and prohibited transaction rules can substantially impact many practices that are otherwise common industry practice, you must pay careful attention to the entity's initial structure and continuing operation so that the manager is fully aware of the entity's plan asset status.