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# HRO Alert

## NEW ERISA PLAN ASSET RULES

### ERISA FIDUCIARY STANDARDS FOR PRIVATE INVESTMENT FUNDS AND OTHER NON-PUBLIC ENTITIES

On August 17, 2006, the Pension Protection Act of 2006 (“**Act**”) became effective. The Act includes the much-anticipated new ERISA plan asset rules. Although they apply to most non-public entities, the new rules most significantly affect private investment funds.

The new rules effectively increase the amount of employee benefit plan assets that private funds may manage without subjecting them or their managers to ERISA’s fiduciary standards by:

1. Eliminating certain benefit plans that count toward the so-called 25 percent threshold, the percentage of benefit plan assets that private funds may manage without subjecting the funds and their managers to ERISA’s fiduciary rules.
2. Resolving how private investment funds measure the assets invested by other private funds whose own benefit plan investors exceed the 25 percent threshold.

### THE 25 PERCENT THRESHOLD

The stringent ERISA fiduciary rules apply to employee benefit plan assets and those who manage them. If benefit plans hold a “*significant*” amount of a non-public entity’s equity interests, the entity’s assets are considered to be “plan assets.” That means the entity’s managers are ERISA fiduciaries who must comply with ERISA fiduciary standards.

Benefit plans hold a “significant” amount of an entity’s equity interests if they hold 25 percent or more of the *value* of any equity class. When that occurs, a benefit plan’s assets will include not only the equity interest it holds in the entity (e.g., a limited partnership interest in a private investment fund) but also an undivided interest in each asset the entity holds (e.g., stock in which a private investment fund invests).

### ERISA FIDUCIARY DUTIES

When the underlying assets of a non-public entity are considered benefit plan assets, the entity’s managers are ERISA fiduciaries with respect to ERISA plan investors and the ERISA plans’ participants and beneficiaries. In addition, transactions between the benefit plan, on the one hand, and the entity, its service providers, and other “parties in interest,” on the other hand, are subject to the prohibited transaction rules of ERISA or the Internal Revenue Code (“**Code**”). Such prohibited transactions are subject to both rescission rights and the 15 percent excise tax imposed by the Code.

What does it mean for private investment funds? The fund’s assets are treated as benefit plan assets. As a result, the fund’s managers are subject to ERISA fiduciary standards with respect to benefit plan investors and their participants and beneficiaries. This creates a heightened standard of care and level of regulatory scrutiny for fund managers. As an example, the manager would need to take into account the particular facts and circumstances of the benefit plan in connection with its investment in the fund. For instance, the manager would need to consider, among other things, the benefit plan’s authority to make the investment and the appropriateness of the investment under the plan documents and applicable ERISA rules (e.g., whether the fund’s expected volatility and other intended investment strategies are permitted and appropriate for the plan’s participants and beneficiaries). In addition, the fund manager would need to determine whether the compensation it receives to manage the

fund's assets violates ERISA's prohibited transaction rules, as well as the general prudence and reasonable compensation requirements.

### THE OLD 25 PERCENT STANDARDS

Under the old law, "employee benefit plan investors" whose assets count toward the 25 percent threshold include:

Employer-sponsored benefit plans (ERISA plans as well as governmental, church, and foreign plans that are exempt from ERISA);

IRAs and other non-ERISA plans that are subject to the prohibited transaction rules of the Code; and

An entity – such as a private investment fund – whose assets are treated as plan assets, because benefit plan investments in that entity exceed the 25 percent threshold. It has been unclear whether *all* the assets of the investing entity – or just the percentage of assets held by its benefit plan investors – count toward the 25 percent threshold. The most conservative practice – and therefore safest – has been to include *all* assets of the investing entity as counting toward the 25 percent threshold. This approach – while prudent – increases the assets that must be included as plan assets. For example, in the case of one private investment fund investing in another private investment fund (a so-called fund of funds), if benefit plan investors own 30 percent of the investing fund, then 100% of the assets that fund invests in the other fund are treated as plan assets.

### THE NEW 25 PERCENT STANDARDS

The Act eliminates several benefit plans whose assets count toward the 25 percent threshold, namely, plans that are exempt from ERISA, such as governmental plans, foreign plans, and most church plans. The Act, however, retains IRAs and other plans that are subject to the Code's prohibited transaction rules.

Similarly, the assets of entities that are deemed plan assets (because more than 25 percent of a class of their equity is held by benefit plans) are still included in the definition of plan assets. However, the amount included from these entities' invested assets as plan assets is *proportional* to the investing entity's own benefit plan assets. Back to the fund of funds example, if benefit plan investors hold 30 percent of the investing fund of fund's equity interests, then only 30 percent of the assets the investing fund invests are treated as plan assets.

### EXAMPLES

Here are examples of how the new rules work:

In each example, an investment adviser manages an unregistered investment fund. The fund issues units of a single class of equity interests to various investors, including ERISA plans, ERISA-exempt benefit plans such as government or church plans, and other private investment funds. The fund invests its assets in stocks.

**Example 1:** Private investment fund "A" has 100 equity units that are held as follows:

- 20 units – governmental plans
- 20 units – ERISA plans
- 60 units – all other investors

**Old rule:** Benefit plan investors (the combined amount invested by governmental plans and ERISA plans) hold 40 percent of the fund's equity interests. As a result, the fund's underlying assets – stocks in which the fund invests – are "plan assets."

**New rule:** Under the same facts as above, now only the 20 units held by the ERISA plans are included in the computation. As a result, the fund does not hold plan assets, because benefit plan investors hold less than 25 percent of the fund's equity interests.

**Example 2:** Private investment fund "B" has 100 equity units that are held as follows:

- 20 units – governmental plans
- 10 units – ERISA plans
- 10 units – another private fund in which benefit plan investors hold 50 percent of the equity interests
- 60 units – all other investors

**Old rule:** Benefit plan investors (the governmental plans that are exempt from ERISA, the ERISA plans, and the entity holding plan assets) hold 40 percent of the fund's total units. As a result, the fund's underlying assets are plan assets.

**New rule:** Under the same facts as above, now only the 10 units held by the ERISA plans and five of the units held by the private fund (50 percent of its 10 units) are included. As a result, none of the fund's underlying assets are plan assets.

## CONCLUSION

Given that ERISA fiduciary duties are fact specific – and therefore not easily reduced to black and white rules – most investment fund managers take steps to ensure that benefit plan investors hold less than 25 percent of the value of any class of the fund's equity.

Accordingly, the new definition of plan assets may make it more feasible for managers of non-public entities, particularly those entities with substantial governmental plan investors or other investment funds that are considered plan assets, to accept more capital from ERISA plans without becoming subject to the ERISA fiduciary rules.

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