ROBERTS & HOLLAND LLP

To Our Clients and Friends: *August 30, 2006*

Significant Changes to "Plan Asset" Rules Under Erisa

On August 17, 2006, President Bush signed the "Pension Protection Act of 2006" (the "PPA") into law. Among other sweeping changes made to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), the PPA contains two provisions which significantly modify the rules governing the investment of pension plan assets with respect to transactions occurring after August 17, 2006. As a result of these changes: (a) plan fiduciaries should find greater opportunities to invest pension plan assets in unregistered investment funds; *e.g.*, hedge funds and private equity funds (referred to as "private funds") and (b) managers of private funds should have greater opportunities to allow pension plans to invest in their funds without causing the mangers to become subject to the fiduciary requirements and restrictions that would apply if the assets of their funds were treated as plan assets subject to ERISA.

Under ERISA's regulatory regime, when a pension plan owns an equity interest in a private fund, all of the assets of the private fund and the manager of the private fund become subject to ERISA's fiduciary requirements and prohibited transaction restrictions, unless an exception under the Department of Labor "plan asset" regulation applies. If the assets held under a private fund were subject to ERISA, the investment manager's compensation arrangement with the fund would have to comply with ERISA, various prohibitions with respect to the operation and administration of the private fund would apply, and a transaction could be required to be undone if self-dealing or other restrictions placed on the investment manager were not strictly adhered to, notwithstanding the economic reasonableness and benefit to the pension plan investors of a particular transaction.

Aside from the venture capital operating company and real estate operating company exceptions under the Department of Labor's "plan asset" regulation, private funds commonly rely on the so-called "25 percent test" exception. Prior to the PPA, a private fund would remain outside of ERISA's regulatory regime if less than 25 percent of the value of the equity interests in the private fund were held by employee benefit plans governed by ERISA (*e.g.*, tax qualified pension plans maintained by private or publicly held employers), IRAs, and employee benefit plans that are ***not*** governed by ERISA, such as foreign plans, governmental plans and church plans (collectively defined in the regulation as "Benefit Plan Investors").

The PPA significantly narrows the definition of Benefit Plan Investors by limiting its scope to employee benefit plans that are subject to ERISA and IRAs ("ERISA Investors"). The equity interests of foreign employee benefit plans, governmental plans and church plans, which often represent a substantial amount of the capital pool available to private funds, no longer count towards the 25 percent test. As a result, investment managers of private funds will now be able to

accommodate significantly larger investments by pension plans that are subject to ERISA while still avoiding the application of ERISA to their funds.

For example, a hedge fund holds assets equal to $10 million. A pension fund owns $1 million of equity interests in the fund, foreign retirement plans own $2 million of equity interests in the fund and a governmental pension plan owns $1 million of equity interests in the hedge fund. Under the former 25 percent test, the hedge fund's assets would be subject to ERISA because 40 percent of the equity interest in the fund is held by Benefit Plan Investors. Under the PPA, ERISA Investors would be considered to hold only 10 percent of the equity interests in the fund and the hedge fund's assets would therefore not be subject to ERISA.

Another rule in the Department of Labor "plan asset" regulation provides that if a private fund does not qualify for the exception under the 25 percent test (or any other regulatory exception), all of the fund's underlying assets are considered to be "plan assets" under ERISA if the assets of the private fund are invested in a private fund which invests assets of various private funds (commonly referred to as a "fund-of-funds"). Under this rule, since the hedge fund in the previous example failed the 25 percent test, the full $10 million held by the fund would have been classified as "plan assets." Therefore, if the hedge fund were to invest in a fund-of-funds, the fund-of-funds would have to take into account 100 percent of the hedge fund's investment in analyzing whether or not it satisfied the requirements of the 25 percent test, notwithstanding the fact that Benefit Plan Investors owned 40 percent of the investing hedge fund's equity.

The PPA modifies this rule by providing that a fund-of-funds is considered to hold "plan assets" only to the extent of the percentage of equity actually owned by the ERISA Investors in a private fund which is subject to ERISA. For example, if 30 percent of a private fund's equity is owned by ERISA Investors and the private fund invested $2 million in a fund-of-funds, the fund-of-funds, in performing its own 25 percent test, would take only $600,000 (30 percent of $2 million) into account as an investment from an ERISA Investor rather than the full $2 million which would have been required under the Department of Labor regulation in effect prior to the enactment of the PPA.

Issues to be Considered by Plan Sponsors and Fund Managers

Although the modifications made to the "plan asset" rules by the PPA should increase the opportunities for the fiduciaries of pension plans to increase the level of investment or pursue new investment opportunities in private funds, plan fiduciaries must still comply with ERISA's fiduciary and other requirements when investing pension fund assets in a private fund. Care must be taken to determine whether the governing plan document places any restrictions on such investments and the plan's fiduciary must determine that investment in the private fund is appropriate based upon the plan's funding policy, risk tolerance and the composition of its investment portfolio.

Managers of private funds will want to review their private placement memorandums and general operating guidelines in order to ensure that they are able to take advantage of the less restrictive plan asset rules provided for under the PPA. As noted above, these rules provide them with the opportunity to accept (at least from an ERISA perspective) unlimited investments from

governmental, foreign and church pension funds which are not subject to ERISA and in many instances, greater amounts of investments from ERISA Investors.

If you have any questions or would like further information about these changes, please call Norman J. Misher at (212) 903-8733; Allen J. Erreich at (212) 903-8769; or Howard W. Hans at (212) 903-8767.

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