Schulte Roth & Zabel

# Alert

## ERISA Considerations for Investment Managers — COVID-19 and Volatile Markets

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Among the many challenges and issues to be addressed by investment managers in connection with COVID-19, investment managers must not lose sight of the specific issues that arise under the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

Please see our other *SRZ Alerts* relevant to investment managers posted on our COVID-19 Resource Center, available here. See our *Alert* for tax issues raised or exacerbated by current market conditions and buying opportunities, available here, our *Alert* on cybersecurity, available here, our various *Alerts* on regulatory updates and our *Alert* on considerations for private equity fund sponsors, available here.

**25% Test**

ERISA issues can arise regardless of whether a fund is intended to be subject to ERISA (i.e., because 25% or more of the NAV of any class of equity in the fund is owned by U.S. private pension plans, IRAs and fund-of-funds whose underlying investors are heavily U.S. private pension plans and IRAs, so called "benefit plan investors") or the fund is intended not to be subject to ERISA (i.e., because the fund restricts ownership of each class of equity interests by benefit plan investors to less than 25%).

*Subscriptions and Redemptions*

1. Under ERISA, each time there is a subscription or redemption from a fund, the investment manager is required to recalculate the benefit plan investor percentage of the NAV for each class of equity in the fund.
2. If the fund's offering material (or a side letter) commits to limiting investment by benefit plan investors to less than 25% of each class of equity of the fund, then withdrawals must be handled in a manner that preserves that commitment (e.g., by compulsory redeeming benefit plan investors to maintain the 25% ratio or by suspending redemptions).

*Fund Restructuring*

1. The 25% test also must be run in connection with various forms of fund restructuring.
2. If restructuring bifurcates the fund's investments disproportionately among its investors (i.e., so that not all investors share in the same portfolio), ERISA's 25% test must be applied to each separate portfolio, on a class-by-class basis, as if it were a separate entity (regardless of whether an actual legally separate entity is created).

*New SPVs*

1. If restructuring involves the transfer of assets to a new SPV, ERISA's 25% test must be applied to the SPV, on a class-by-class basis.
2. If the underlying fund committed to limit investment by benefit plan investors to less than 25% of each class of equity of the fund, the SPV must also impose that limitation on benefit plan investors.

*Side Pockets*

1. If a fund's portfolio is not totally bifurcated but certain assets are side pocketed, ERISA's 25% test must be applied separately to each side pocket as if it were a deemed separate entity, as well as the main fund.
2. If a fund complies with the 25% test when the side pocket is established and investors' ownership of the side pocket is proportionate to their ownership in the main fund, the side pocket should also meet the 25% test.
3. If the investors' ownership of the side pocket is not proportionate to their ownership in the main fund — likely because investors are given opt-in/opt-out rights — then the side pocket may not meet with the 25% test. For example, if too many non-benefit plan investors opt out of the side pocket versus benefit plan investors that opt in, the ownership percentage by benefit plan investors will increase, potentially causing the side pocket not to meet the 25% test. To address this potential risk, side-pocket election forms should provide that an investor's election will be implemented, to the fullest extent possible, but subject to the need of the side pocket to meet the 25% test.

*New Classes*

1. If a fund chooses to deal, in whole or in part, with dislocations caused by the current economic situation by creating a new class or classes of equity with different liquidity terms than the existing classes, the 25% test must be rerun taking into account the investors in each equity class (both the old classes that still exist and any new class of shares).
2. If the fund committed to limit investment by benefit plan investors to less than 25% of each class of equity of the fund, the fund must ensure that benefit plan investors continue to own less than 25% of each equity class.

*Redemptions*

1. If a fund adopts a "slow pay mechanism" to effect redemptions, the portion of the fund consisting of slow pay assets may be deemed for purposes of ERISA's 25% test as a separate entity.

2. If the fund committed to limit investment by benefit plan investors to less than 25% of each class of equity of the fund, the fund must ensure that that the portion of the fund consisting of the slow pay assets meets the 25% test by monitoring which investors redeem on a specific redemption date.

*Master-Feeder Structures*

1. With respect to a master-feeder structure where the feeder assets are "hard wired"[1] into a master fund that is designed to meet the 25% test, any actions, such as a restructuring, should ensure that the master fund continues to meet the 25% test.

**ERISA Plan Asset Funds**

The 25% test should not be a concern if a fund has been designed to hold plan assets (commonly called, "plan asset fund") and comply with ERISA's requirements (i.e., because the fund does not limit investment by benefit plan investors to meet the 25% test). However, in the context of the rapid actions that might be made during the quickly evolving financial market, managers of plan asset funds must continue to ensure their compliance with ERISA.

1. Any restructuring involving a plan asset fund must ensure compliance with ERISA fiduciary duties — such as prohibitions on conflict of interest transactions.
2. Managers of plan asset funds must be mindful of possible conflict of interest issues that can arise where investments made by a side pocket, SPV or new fund "face off" against the main fund or another fund managed by the manager.
3. Any conflicts that may arise must be resolved in a manner that is ERISA compliant and disclosures should be made in the new fund's offering documents.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] In that situation the feeder (typically the offshore feeder) is permitted to allow investment by benefit plan investors to exceed 25% of a class of equity in the feeder as long as benefit plan investment in the feeder does not cause the master fund to violate the 25% limitation.