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Schulte Roth & Zabel

Partner
New York Office
+1 212.756.2141
david.cohen@srz.com

Practices

- Employment & Employee Benefits
- Hedge Funds
- Private Equity
- Regulatory & Compliance
- Trading Agreements

David M. Cohen

David focuses his practice on matters related to fiduciary responsibility, the Employee Retirement Income Security Act of 1974 (ERISA) and qualified plans. Prior to joining SRZ, David held positions in both the private sector (as vice president and assistant general counsel of a major investment firm) and government service (with the Department of Labor Employee Benefits Security Administration's Divisions of Regulatory Coordination and Exemptions).

In recognition of his accomplishments, David has been selected for inclusion in *Chambers USA*, *The Best Lawyers in America* and in *New York Super Lawyers*, a listing of outstanding attorneys in the New York metro area. He has spoken and written widely on ERISA and benefit fund-related issues, including authoring ERISA compliance guides for broker-dealers for Practising Law Institute. He is also a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). David recently presented "What You Need to Know When ERISA Plans Come Knocking" at the SRZ London Breakfast Briefing and "Current Fiduciary Issues" at the Practising Law Institute Pension Plan Investments 2014: Current Perspectives conference.

David earned a J.D. from The George Washington University Law School and a B.A. from Columbia University.

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Partner
New York Office
+1 212.756.2009
jennifer.dunn@srz.com

Practices

Investment Management
Hedge Funds
Private Equity

Jennifer Dunn

Jennifer advises hedge funds, private equity funds (including mezzanine and distressed funds), hybrid funds, funds of funds and investment advisers in connection with their structuring, formation and ongoing operational needs, general securities law matters, and regulatory and compliance issues. Her experience includes structuring and negotiating seed and strategic investments, advising investment managers regarding the structure and sale of their investment management businesses and the structure of their compensation arrangements, and representing investment managers in connection with managed accounts and single-investor funds.

Recognized by *The Legal 500 United States* and the *Expert Guide to the World's Leading Women in Business Law* (Investment Funds) and as an IFLR 1000 Rising Star (Investment Funds), Jennifer recently co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and presented at conferences sponsored by the New York City Bar Association, 100 Women in Hedge Funds, KPMG and Bank of America Merrill Lynch. She also presented "Marketing Opportunities and Challenges" at the SRZ 23rd Annual Private Investment Funds Seminar and participated in the "Allocation of Investment Opportunities Workshop" at an SRZ Investment Management Hot Topics seminar.

Jennifer earned her J.D. from Columbia University Law School, where she was a Harlan Fiske Stone Scholar, and her B.A., *cum laude*, from the University of Pennsylvania.

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Partner
New York Office
+1 212.756.2567
steven.fredman@srz.com

Practices

Investment Management
Hedge Funds
Private Equity
Regulatory & Compliance
Securities & Capital Markets

Steven J. Fredman

Steve is co-head of SRZ's Investment Management Group. He concentrates his practice in the areas of investment funds (domestic and offshore), investment advisers and broker-dealers, the acquisition and related financing of investment management firms, and securities regulation. Steve structures and organizes private investment partnerships and offshore funds, including general equity, arbitrage, global investment, private equity, distressed company, small cap and funds of funds, and he counsels clients on issues relating to partnership law, new product development and other matters. He also structures and organizes investment advisers and broker-dealers, handles the registration of commodity pool operators and commodity trading advisers, and provides ongoing advice to investment advisers on securities laws, rules, regulations and information. He represents clients in connection with the acquisition and sale of investment management firms or their assets as well.

Steve is recognized by many ranking publications, including *Chambers Global*, *Chambers USA*, *The Legal 500 United States*, *Expert Guide: Best of the Best USA* (Investment Funds), *Expert Guide to the World's Leading Investment Funds Lawyers*, *Expert Guide to the World's Leading Private Equity Lawyers*, *International Who's Who of Private Funds Lawyers* and *The Best Lawyers in America*. A past member of the American Bar Association's Committee on Partnership and the New York City Bar Association's Committee on Art Law, Steve is a frequent speaker and writer in his areas of expertise. He most recently presented at the Goldman Sachs Seventeenth Annual Hedge Fund Conference, and he discussed "Distressed Investments: Structured Products" at the SRZ 23rd Annual Private Investment Funds Seminar. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and "Asset Manager M&A Deals," an SRZ white paper.

Steve holds a J.D. from Georgetown University Law Center, where he was an editor of *Law and Policy in International Business*, and a B.A. from Columbia University, where he was Phi Beta Kappa.

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Partner
New York Office
+1 212.756.2529
ian.levin@srz.com

Practices

Employment & Employee Benefits

Mergers & Acquisitions

Executive Compensation

Ian L. Levin

Ian's practice concentrates on executive compensation and employee benefits, with a focus on the employee benefit aspects of mergers and acquisitions and issues arising from the investment of pension plan assets. He represents both executives and companies with respect to the negotiation and drafting of executive employment agreements and advises as to the design and establishment of virtually all types of employee benefit arrangements ranging from cash incentive, equity, deferred compensation and change-in-control arrangements to broad-based retirement and welfare plans. He also advises clients on fiduciary and plan asset requirements of ERISA, including the structure and offering of various securities and securities products; the formation and ongoing compliance of private equity and hedge funds; the administration, management and investment of employee benefit plans; and compliance with ERISA's various prohibited transaction rules and exemptions.

Ian has been recognized as a leading employment and employee benefits attorney by *The Legal 500 United States*, which noted that he "operates at a very high level across many areas, but brings a particularly unique set of skills to ERISA Title I matters in his representation of private investment funds." He also serves as an adjunct professor at New York Law School. Ian has written articles for *The Metropolitan Corporate Counsel* about ERISA and incentive-based compensation regulations, and his recent speaking engagements include addressing several New York City Bar Association conferences.

Ian received his LL.M. from New York University School of Law, his J.D. from Emory University School of Law and his B.A. from Union College.

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Partner
New York Office
+1 212.756.2048
ronald.richman@srz.com

Practices

- Employment & Employee Benefits
- Mergers & Acquisitions
- Regulatory & Compliance
- Insurance
- Executive Compensation

Ronald E. Richman

Ron is co-head of SRZ's Employment & Employee Benefits Group and a member of the firm's Executive Committee. His practice concentrates on the litigation of employment and employee benefits cases in federal and state courts throughout the United States involving trade secrets, non-competition, non-solicit, and breach of confidentiality and breach of loyalty issues. Ron defends employee benefit plans, fiduciaries, and employers in class actions and in cases brought by individual plaintiffs. He represents employee benefit plans before the U.S. Department of Labor, the Pension Benefit Guaranty Corporation and the Internal Revenue Service in connection with novel issues of law concerning plan mergers, terminations, spin-offs, fiduciary duties and prohibited transactions, and various aspects of withdrawal liability and mass withdrawal liability. He also represents employers (particularly hedge and private equity funds), employees and partners with respect to executive compensation and partnership issues.

Recognized by *New York Super Lawyers* and *The Best Lawyers in America* as a leading labor and employment litigation attorney, Ron is a Fellow of the American College of Employee Benefits Counsel and a member of the CPR Employment Dispute Committee of the CPR Institute for Dispute Resolution. He is a former board member for the Lawyers Alliance for New York and a former adjunct professor in the New York University School of Continuing Education's Certified Employee Benefits Specialist Program. Ron frequently speaks and writes on employee benefits and employment topics of interest to the human resources community. He most recently presented "Understanding Pension Plan Liabilities" at the SRZ 3rd Annual Distressed Investing Conference, and he participated in an SRZ Employment & Employee Benefits Luncheon for Investment Managers. He also recently published "ERISA Presumption of Prudence in 'Stock Drop' Cases Rejected" in the *New York Law Journal*.

Ron received his J.D. from Columbia University School of Law, where he was a Harlan Fiske Stone Scholar and the recipient of the Emil Schlesinger Labor Law Prize, and his B.S. from the Industrial and Labor Relations School at Cornell University.

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ERISA: From No Plan Assets to Managing Plan Assets

Introduction

The Employee Retirement Income Security Act of 1974 ("ERISA") imposes significant responsibilities (so-called "fiduciary responsibilities") on persons who manage or provide services to employee benefit plans, directly or through so-called plan asset look-through vehicles, and it imposes important restrictions on transactions involving employee benefit plans (or involving the investment of the assets of such plans). Additional responsibilities and restrictions are imposed under the Internal Revenue Code of 1986 (the "Code"). This outline summarizes the most important of these rules and restrictions applicable to managers of hedge funds in circumstances in which investment in the fund by employee benefit plans causes the hedge fund to be a "plan asset look-through vehicle."

ERISA operates by: (1) prohibiting broad categories of transactions between a plan and the people who manage or provide services to the plans; (2) providing statutory exemptions from all or part of the prohibitions for specific kinds of transactions; and (3) permitting the Department of Labor ("DOL") to grant individual or industry-wide exemptions ("class exemptions") from all or part of the prohibitions for specific kinds of transactions. Therefore, analyzing whether a particular transaction is permissible is usually a two-step process: First, does the transaction or service fall within the broad prohibitions? If so, then second, is any exemption available to permit the transaction or service? To the extent that an exemption is available, the hedge fund manager must understand and strictly comply with the conditions set forth in the exemption. Failure to do so may render the exemption meaningless.

This outline is organized as follows:

Section I contains a discussion of the terms used in ERISA and summarizes the broad prohibitions of ERISA.

Section II discusses the circumstances in which the investment by employee benefit plans in a hedge fund will cause the fund to be a plan asset look-through vehicle that is subject to ERISA, and the consequences to the fund's investment manager if the fund attains plan asset look-through status.

Section III discusses the consequences to an ERISA-covered plan of investing in a plan asset look-through hedge fund.

Section IV discusses a specific class exemption (the so-called "QPAM Exemption") issued by the DOL that permits certain categories of transactions and services in the event that a hedge fund attains plan asset look-through status.

Section V discusses a specific statutory exemption that permits certain categories of transactions and services in the event that a hedge fund attains plan asset look-through status.

Section VI discusses special prohibited transaction concerns that arise in managing a plan asset look-through hedge fund and how to handle those concerns.

Section VII discusses increasing ERISA capacity while trying to avoid plan asset look-through status, also known as "the hard wired feeder concept."

I. General Application of the Fiduciary Provisions

A. Coverage

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1. ERISA

The fiduciary responsibility and prohibited transaction provisions of Title I of ERISA, which impose responsibilities on plan fiduciaries and which regulate plan dealings with providers of services and other parties in interest, apply generally to "employee benefit plans," whether or not such plans are "qualified plans" under the Code.[1] However, a DOL regulation provides that the term "employee benefit plan" does *not* include: (1) an individual retirement account, annuity or bond created by an individual employee, to which his employer does not contribute;[2] (2) a plan which covers only the sole owner of a business (incorporated or unincorporated) and/or his spouse (a "one-man" plan);[3] or (3) a plan which covers only partners and their spouses (a "partner-only" plan).[4]

NOTE: Although IRAs, one-man plans and partner-only plans are not covered by ERISA's fiduciary responsibility rules, they *are* subject to restrictions imposed by the Code, as discussed below.

ERISA also excludes from its fiduciary responsibility rules those plans maintained by governmental bodies, certain plans maintained by churches and certain plans maintained by private employers primarily for the purposes of providing deferred compensation for a select group of management or highly compensated employees. However, plans maintained by tax-exempt organizations *other* than governmental bodies and churches *are* subject to ERISA's fiduciary responsibility provisions,[5] and governmental plans may be subject to ERISA-like fiduciary responsibility rules imposed under state law.

2. Internal Revenue Code

The provisions of the Code regulating transactions involving employee benefit plans apply to individual retirement accounts, annuities or bonds, and so-called "qualified plans" (including one-man plans and partner-only plans). Although the prohibited transaction provisions of the Code generally do not apply to non-qualified employee benefit plans, they do continue to apply to a plan that was once qualified but later became disqualified.[6]

NOTE: It is important to keep in mind that, since IRAs, one-man plans and partner-only plans are subject to the Code, the prohibited transaction rules imposed by the Code apply to these accounts and plans even though they are exempt from the ERISA fiduciary responsibility rules. The fiduciary obligations imposed solely by ERISA, which do *not* apply, are summarized in part D of Section I. The prohibited transaction rules, which are imposed both by ERISA and by the Code, and which *do* apply to IRAs, one-man plans and partner-only plans, are summarized in part E of Section I.

B. Definition of Fiduciary

ERISA and the Code regulate the activities of "fiduciaries." A person is a fiduciary with respect to a plan asset look-through hedge fund to the extent he or it:

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[1] ERISA § 401(a); 3(3).

[2] Labor Reg. § 2510.3-2(d).

[3] Labor Reg. § 2510.3-3(b).

[4] Labor Reg. § 2510.3-3(b).

[5] DOL News Release (Jan. 12, 1987).

[6] Code § 4975(e)(1).

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1. Exercises any discretionary authority or control with respect to the management of a fund or the management or disposition of the fund's assets;

2. Renders investment advice to the fund for a fee or compensation, direct or indirect, with respect to any moneys or property of the fund or has any authority or responsibility to do so; or

3. Has any discretionary authority or discretionary responsibility in administering the fund.[7]

This statutory test is a purely functional test. Thus, the fiduciary of a plan asset look-through hedge fund will be the entity that calls the investment shots for the fund. Depending on the structure of the fund, this may not be the general partner of a partnership, the managing member of an LLC or the board of directors of an offshore corporation if such person or entity does not perform any of the functions set forth in the statute and quoted above.

C. Definition of Party in Interest

ERISA and the Code also restrict transactions involving a plan and a "party in interest." The Code does not use the term "party in interest" but refers instead to a "disqualified person." The definition of a "disqualified person," though not identical to that of "party in interest," is sufficiently similar so that, for simplicity, the term "party in interest" will be deemed to include a "disqualified person" for purposes of this outline. A "party in interest" is defined to include:

1. Any fiduciary (including by definition a trustee);

2. Any person providing services to a plan;

3. An employer whose employees are covered by the plan;

4. A union or other employee organization whose members are covered by the plan;

5. An owner of a 50-percent or more interest in an entity described in (3) or (4);

6. A relative of an individual described in (1), (2), (3) or (5). "Relative" includes a spouse, ancestor, lineal descendant or spouse of a lineal descendant;[8]

7. An entity 50 percent or more of which is controlled, directly or indirectly, by individuals or entities described in (1), (2), (3), (4) or (5);

8. An employee, officer, director or a person directly or indirectly controlling 10 percent or more of an individual or entity described in (2), (3), (4), (5) or (7); or

9. A person who is a 10 percent or more partner or joint venturer in an individual or entity described in (2), (3), (4), (5) or (7).[9]

(The percentages in (7), (8) and (9) may be, but have not been, lowered by regulation.)

D. General Duties of a Fiduciary

[7] ERISA § 3(21)(A); Code § 4975(e)(3).

[8] ERISA § 3(15); Code § 4975(e)(6).

[9] ERISA § 3(14); Code § 4975(e)(2); Advisory Opinion 75-147.

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Under ERISA, a fiduciary's general obligations with respect to a plan asset look-through hedge fund are, briefly, the following:

1. He must discharge his duties solely in the interest of participants and beneficiaries of the investing ERISA-covered employee benefit plans for the exclusive purpose of providing benefits under and defraying reasonable administrative costs of such plans.[10]

2. He must act with the care, skill, prudence and diligence under the prevailing circumstances that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and like aims.[11]

3. He must diversify plan investments so as to minimize the risk of large losses (with certain very limited exceptions).[12]

4. He must discharge his duties in accordance with the documents governing the investing plans to the extent that such documents are consistent with ERISA.[13]

5. Except as authorized by regulation, he may not maintain title to assets of the fund outside the jurisdiction of the district courts of the United States.[14] The DOL issued a regulation that allows certain persons to maintain assets outside the United States under limited circumstances.[15] Under this regulation, a fiduciary may purchase securities issued by a foreign corporation or governmental entity, or whose principal trading market is outside of the United States, if the fiduciary is a corporation or partnership organized under United States or state law that has its principal place of business in the United States, provided that the fiduciary is a registered investment adviser (or a bank or insurance company) with $50,000,000 under management and either: (1) over $750,000 in shareholders' or partners' equity; or (2) all of its liabilities are assumed or guaranteed by a bank, insurance company, another investment adviser with over $750,000 in shareholders' or partners' equity, or a registered broker or dealer with a net worth of over $750,000.

6. He may not permit the fund to acquire or hold employer securities or employer real property of the investing plans in excess of certain specified limitations.[16]

Under applicable DOL regulations, a fiduciary is considered to satisfy the requirement that he act with the care, skill, prudence and diligence of a prudent man with respect to his investment duties if, with regard to a particular investment or investment course of action, he gives appropriate consideration of the facts and circumstances which, given the scope of his investment duties, he knows or should know are relevant to a particular investment or investment course of action. Thus, under the regulation, the fiduciary should consider the role that the particular investment or investment course of action plays in the fund's overall investment portfolio. The fiduciary should determine whether the particular investment or investment course of action is reasonably designed, as part of the fund's investment portfolio, to further the purpose of the fund given the risk of loss and opportunity for gain (or other

[10] ERISA § 404(a)(1)(A); Code § 401(a).

[11] ERISA § 404(a)(1)(B). This is sometimes referred to as the prudent expert standard. It is a higher standard than the common law fiduciary standard of a general partner to a partnership.

[12] ERISA § 404(a)(1)(C).

[13] ERISA § 404(a)(1)(D).

[14] ERISA § 404(b).

[15] Labor Reg. § 2550.404b-l.

[16] ERISA § 406(a)(2).

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return) associated with the investment. Among the factors that a fiduciary should consider are the composition of the fund's investment portfolio and its diversity or lack thereof, the liquidity, rate of return and cash flow needs of the fund and the projected return from the fund's investments relative to other types of investments.

E. Prohibited Transactions

Under ERISA, a fiduciary may not engage in a prohibited transaction with a plan asset look-through hedge fund nor cause the fund to engage in a prohibited transaction with a party in interest. The penalties imposed on fiduciaries and on parties in interest for violations of these rules are discussed in detail in Appendix A. Except as otherwise indicated below, these rules are imposed both by ERISA and by the Code.

1. Prohibited transactions involving fiduciary self-dealing:

(a) Dealing with the assets of the plan in the fiduciary's own interest or for his own account (e.g., effecting a securities transaction through a broker-dealer that is an affiliate of the plan asset look-through hedge fund manager or purchasing a security with fund assets for the purpose of maintaining the price of the security for the benefit of such a broker-dealer or its other customers).[17]

(b) Acting on behalf of a party whose interests are adverse to the interests of the plan in any transactions involving the plan (e.g., the manager of a plan asset look-through hedge fund crosses the fund's securities trades with another hedge fund managed by the same manager).[18] (ERISA only.)

(c) Receiving any consideration for its own account from any party dealing with the plan in connection with a transaction involving the plan's assets (e.g., the manager of a plan asset look-through hedge fund receives a fee or other thing of value from an unaffiliated broker in return for the manager selecting that broker to execute trades for the fund).[19]

These prohibited transaction rules are intended to prevent the fiduciary from engaging in any acts of self-dealing or in transactions where the fiduciary has, or may have, a conflict of interest.

2. Prohibited transactions between a party in interest (including any fiduciary) and a plan asset look-through hedge fund:

(a) Sale, exchange or lease of property.[20]

(b) Loans and other extensions of credit, including margin loans and short sales. (However, see the exemption for certain margin loans and short sales discussed below in Section IV of this outline.)[21]

(c) Furnishing of goods, services or facilities.[22]

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[17] ERISA § 406(b)(1); Code § 4975(c)(1)(E).

[18] ERISA § 406(b)(2).

[19] ERISA § 406(b)(3); Code § 4975(c)(1)(F). A violation of this section may give rise to criminal penalties. 18 U.S.C. § 1954.

[20] ERISA § 406(a)(1)(A); Code § 4975(c)(1)(A).

[21] ERISA § 406(a)(1)(B); Code § 4975(c)(1)(B).

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(d) Transfers to, or use by a party in interest of, any fund assets.[23]

(e) Subject to certain exceptions, acquisition by a party in interest, on behalf of the fund, of any employer security or employer real property.[24] (ERISA only.)

F. Liability for Breach of Co-Fiduciary

In addition to any liability that a fiduciary may have for his own breaches of fiduciary duty, he is liable for the breach of another fiduciary of the same plan asset look-through hedge fund if:

1. He knowingly participates in or undertakes to conceal a breach of fiduciary duty which he knows to be a breach;

2. He enabled such fiduciary to commit the breach by not discharging his own fiduciary duties properly; or

3. He is aware that the breach has occurred, unless he takes reasonable steps to remedy the breach.[25]

Accordingly, if one plan fiduciary has knowledge of another plan fiduciary's breach of fiduciary responsibility, he has an affirmative duty to make reasonable efforts to remedy the breach. Failure to do so will expose the fiduciary to potential liability for the acts of the offending fiduciary. The DOL regulations provide that mere resignation is not sufficient to discharge the fiduciary's positive duty to make reasonable efforts to remedy a breach.[26]

II. Determining If a Hedge Fund Holds Plan Assets

In 1986, the DOL promulgated a regulation (commonly referred to as the "Plan Asset Regulation")[27] to set forth the circumstances under which the assets of an entity in which a "benefit plan investor" invests will be treated as "plan assets" of such investor (and the entity will thus be treated as a plan asset look-through entity). In August 2006, the Pension Protection Act enacted new rules (Section 3(42) of ERISA) for determining when an entity in which a benefit plan investor invests will be treated as a "plan asset vehicle." These rules supersede, in part, the Plan Asset Regulation.

Generally, under the Plan Asset Regulation (as modified by Section 3(42) of ERISA), when a benefit plan investor purchases an equity interest of an entity which is neither a publicly offered security, nor a security issued by an investment company registered under the Investment Company Act of 1940, the benefit plan investor's assets will include only its equity interest in the entity. However, if benefit plan investors own 25 percent or more of any class of the equity interests in the entity, that entity will be a plan asset look-through entity. As a result, the benefit plan investor's assets will include not only its equity interest in the entity, but also an undivided interest in each of the underlying assets of the entity. Further, any entity providing services to the entity will be deemed to be providing services to each of the investors that is subject to

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[22] ERISA § 406(a)(1)(C); Code § 4975(c)(1)(C).

[23] ERISA § 406(a)(1)(D); Code § 4975(c)(1)(D). This prohibition would bar the investment manager of a plan asset look-through hedge fund from receiving any soft dollars from the broker-dealers through which the investment manager executes the fund's trades. However, in Technical Release 86-1, the DOL recognized that Section 28(e) of the Securities Exchange Act of 1934 was passed after ERISA and thus preempts ERISA's ban on the receipt of soft dollars. This preemption only applies to "soft dollars" that fall completely within the scope of Section 28(e). Thus, a manager's receipt of non-28(e) soft dollars (such as rent subsidies, free trips, apartment rentals, etc.) would be prohibited.

[24] ERISA § 406(a)(1)(E).

[25] ERISA § 405(a).

[26] Labor Reg. § 2509.75-5 FR-10.

[27] Labor Reg. § 2510.3-101.

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ERISA and/or the prohibited transaction provisions of the Code, causing the service provider to be a party in interest to each such investing plan. Similarly, the investment manager of the entity will be deemed to be providing investment management services to each of the investors that is subject to ERISA and/or the prohibited transaction provisions of the Code. Accordingly, the investment manager of a plan asset look-through entity will be a fiduciary to each such investing plan and thus subject to ERISA's fiduciary responsibility provisions discussed in Section I of this outline.

Under Section 3(42) of ERISA, the determination of whether an entity is a plan asset vehicle is made immediately after the most recent acquisition of any equity interest in the entity. Section 3(42) of ERISA further provides that this determination must be made by disregarding the value of any equity interests held by a person (other than a benefit plan investor) who has discretionary authority or control with respect to the assets of the entity or any person who provides investment advice for a fee (direct or indirect) with respect to such assets, or any affiliate of such a person.

Neither Section 3(42) of ERISA nor the Plan Asset Regulation addresses the treatment of a redemption of an equity interest or an intra-family transfer; the term "acquisition" is undefined. In an advisory opinion letter (Advisory Opinion 89-05A) dated April 5, 1989, the DOL indicated that, in its view, the redemption of a partner's equity investment in a partnership would constitute an acquisition, triggering a test of the level of benefit plan investor participation in the entity because the redemption would result in an increase in the interests of the remaining partners. The DOL also stated that, in its view, intra-family transfers of equity interests in a partnership, whether by devise or inheritance, also would trigger the benefit plan investor level of participation test.

Section 3(42) of ERISA defines the term "benefit plan investor" to include: (1) any employee benefit plan, as defined in Section 3(3) of ERISA, that is subject to the provisions of Title I of ERISA (e.g., U.S. private pension and health and welfare plans); (2) a plan that is subject to the prohibited transaction provisions of Section 4975 of the Code (e.g., ERISA-covered employee benefit plans, individual retirement accounts and Keogh plans); and (3) any entity whose assets are treated as "plan assets" by reason of an employee benefit plan's investment in the entity, but only in the proportion that is equal to benefit plan investor ownership of the entity. Appendix B provides a list of common types of plans and entities that are considered benefit plan investors.

The Plan Asset Regulation provides that an "affiliate" of a person includes any person, directly or indirectly, through one or more intermediaries, controlling or controlled by, or under common control with, the person. For purposes of this definition, "control" with respect to a person other than an individual means the power to exercise a controlling influence over the management or policies of such person.

The Plan Asset Regulation sets forth three special exceptions under which benefit plan investors will not be deemed to have an interest in the underlying assets of an entity, regardless of the amount of equity in the entity that is held by benefit plan investors. First, if the security is a publicly offered security; second, if the entity is an operating company; and third, if the entity is an investment company registered under the Investment Company Act of 1940.

III. Consequences to an ERISA-Covered Plan of Investing in a Plan Asset Look-Through Hedge Fund

A. Trustees May Be Relieved of Their Duty to Manage Plan Assets

ERISA provides that the trustees of a plan are vested with the exclusive authority and discretion to manage the assets of the plan.[28] The trustees must fulfil this responsibility in accordance with the

[28] ERISA § 403(a)(1).

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fiduciary responsibility provisions of ERISA discussed in part D of Section I of this outline. Thus, regardless of their financial education or sophistication, the trustees of the plan will be held to an extremely high standard of behavior. Congress recognized that this was somewhat unfair and thus relieved the trustees of their responsibility for day-to-day management of the plan's assets as long as the authority to manage and control the assets of the plan has been delegated to an investment manager.[29]

ERISA provides that if an investment manager has been appointed, the trustees will not be liable for the acts or omissions of the investment manager, nor will they be obligated to invest or otherwise manage the assets entrusted to the investment manager.[30] This major relief was enacted to encourage professional plan management. However, the relief is only available if the entity that is managing plan assets meets the definition of an investment manager set forth in Section 3(38) of ERISA. ERISA defines an investment manager to include a bank, an insurance company and, most significantly, a registered investment adviser.[31] Thus, hiring an unregistered adviser provides no relief for the plan trustees. In fact, the opposite is true. The trustees will retain full liability for the acts or omissions of the unregistered adviser as if they were the acts or omissions of the trustees themselves. It is for this reason that the investment manager of a plan asset look-through hedge fund must be registered as an investment adviser unless the manager is either a bank or an insurance company. Without that, the trustees of each benefit plan investor that is an ERISA-covered plan will be responsible for the individual decisions of the plan asset look-through hedge fund manager as if they themselves made those decisions.

B. Special Reporting Requirements

In general, each benefit plan investor that is covered by ERISA or the prohibited transaction provisions of the Code is required to file an annual report (Form 5500) with the DOL and the IRS. One item required by the annual report is a list of all the assets of the plan, including the fair market value of each asset. Therefore, each plan is required to include information regarding each asset held by a plan asset look-through hedge fund. However, as an alternative, each such plan may include on its annual report solely the value of its interest in the hedge fund, provided that the hedge fund files certain information with the DOL regarding the hedge fund's investments and expenses for the year. Many plans prefer to rely upon this alternative, and the fund should furnish timely valuation information to each such plan investor.

As a separate matter, beginning in 2009, the DOL began to require a plan to report certain direct and indirect compensation paid by the plan in connection with its investments. A plan is expected to request this information from the various investment managers and investment vehicles in which the plan invests. This information is filed on Schedule C to the plan's Form 5500. In connection with a plan asset look-through hedge fund, all of the compensation that the plan is required to report would be indirect compensation unless the plan paid a placement agent directly in connection with its investment in the hedge fund. Indirect compensation includes the management and incentive fees paid by the hedge fund, brokerage amounts in excess of pure execution fees, entertainment received by the hedge fund manager from its service providers, and any other fees paid to the hedge fund manager by third parties in connection with the investment of the hedge fund's assets (for example, if an entity in which the hedge fund invests then pays consulting fees to the hedge fund manager or an affiliate because of the hedge fund's investment in that entity). Plans request this compensation information in many different formats, and we suggest that the investment manager of a plan asset look-through hedge fund develop

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[29] ERISA § 403(a)(2).

[30] ERISA § 404(d)(1).

[31] ERISA § 3(38).

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its own model response rather than attempting to complete the various forms it receives from the ERISA-covered investors.

C. Bonding Requirement

To protect employee benefit plans against loss as a result of fiduciary misconduct, ERISA requires that certain plan fiduciaries be bonded in an amount equal to the lesser of 10 percent of the funds handled by such fiduciaries or $500,000.[32] The Pension Protection Act of 2006 raised this number to $1 million if a plan holds securities of its plan sponsor. However, it is unclear whether every fiduciary handling a plan's assets needs to maintain the $1 million (rather than $500,000) coverage, or only those who invest in employer securities. A letter was filed with the DOL on this issue that took the position that if a fiduciary does not invest in employer securities, it should be allowed to purchase the lower bond, regardless of whether other investment managers for the plan have purchased the plan sponsor's securities. If the DOL's response is that every manager of a plan holding employer securities will have to purchase a $1 million bond, then the investment manager of a plan asset look-through hedge fund would purchase the bigger bond as it is highly unlikely that the investment manager would keep tabs on the plan's other holdings.

Regardless of the answer to the question regarding the amount of the ERISA Section 412 bond, the investment manager of a plan asset look-through hedge fund must obtain such a bond, which names the client plan as the insured. In the alternative, the investment manager may provide by contract that each ERISA-covered investing plan will cover the investment manager of the fund on an agent's rider to the plan's fidelity bond. This complies with the provisions of Section 412 of ERISA, but larger plans often push back on this requirement and may require the manager to agree to obtain the bond in a side letter.

IV. Class Exemption from the Prohibited Transaction Rules of ERISA for Qualified Professional Asset Managers

In 1984, in recognition of the fact that the definition of the term "party in interest" was so broad that it caused many beneficial and appropriately priced transactions to become prohibited, the DOL granted extensive relief to professional asset managers in their dealings with "remote" parties in interest with respect to their plan clients. PTCE 84-14 (the "QPAM Exemption")[33] provides that a plan that is managed by a qualified professional asset manager ("QPAM") may enter into a transaction described in Section 406(a) of ERISA (such as a loan, lease, provision of services, etc. between a plan and a party in interest) which would otherwise be prohibited if, at the time of the transaction: (1) neither the party in interest nor any of its affiliates has the power to hire or fire the QPAM or to negotiate the terms of the QPAM's management agreement (effectively excluding transactions with the employer sponsoring the plan and its affiliates); (2) it is not a party in interest with respect to a plan or plans of the same employer whose assets constitute 20 percent or more of the QPAM's assets under management;[34] and (3) the party in interest is not the QPAM itself or any of its affiliates. In this scenario, the transaction will not constitute a prohibited transaction as long as the QPAM alone negotiated the terms of the transaction (i.e., the QPAM must have discretionary control over the assets involved in the transaction, and no plan sponsor veto is allowed) and the terms of the transaction were arm's-length terms.

Part VI of the exemption defines a QPAM to include a bank, S&L, insurance company or, most importantly, a registered investment adviser with $85 million under management as of the last day of its most recent fiscal

[32] ERISA § 412.

[33] 49 Fed. Reg. 9494 (March 13, 1984).

[34] In the plan asset look-through entity context, each underlying client of the entity would be measured separately, rather than counting the entity itself as one client of the investment manager.

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year and shareholder's or partner's equity (determined under U.S. Generally Accepted Accounting Principles) of at least $1 million. The $1 million determination is made based on the investment adviser's most recent balance sheet prepared within the last two years preceding the transaction for which QPAM relief is required. However, for convenience, this determination is typically based on the adviser's balance sheet as of the last day of its most recent fiscal year. If an investment adviser fails the net worth test, it may still be a QPAM if the investment adviser and its affiliates together have shareholder's or partner's equity in excess of $1 million and certain affiliate(s) unconditionally guarantee to pay all of the investment adviser's liabilities, including any liabilities that may arise if the investment adviser violates any of its fiduciary obligations to the plan or violates any of the prohibited transaction rules.

The QPAM Exemption provides extensive relief for an investment manager of a plan asset look-through hedge fund, particularly if its investment strategy involves the acquisition of securities on margin, short sale transactions, or entering into swaps. In all of these cases, the transactions give rise to extensions of credit between the plan and the broker-dealer executing the transaction (and are thus prohibited under Section 406(a)(1)(B) of ERISA).[35] The QPAM Exemption allows the QPAM freely to enter into transactions involving the extension of margin credit and to pay interest on any margin debt created in short selling without the need to keep a list of all broker-dealers providing services to the plan.[36] In addition, in connection with a short sale program managed by a QPAM, the plan may borrow the stock (typically from a broker-dealer) to cover the short sale without the need to examine whether the lender is a party in interest. As discussed above, the only limitations in both cases are that the party extending credit cannot be the QPAM or an affiliate of the QPAM, nor can the party possess the power to hire or fire the QPAM.

Another example of the relief provided by the QPAM Exemption is that it allows the investment manager of a plan asset look-through hedge fund to enter into principal trades with broker-dealers that provide execution services to one or more of the fund's benefit plan investors. Because the broker-dealer is a service provider to each such plan, the trade would violate the prohibition of Section 406(a)(1)(A) of ERISA that bars a sale or exchange of property between a plan and a party in interest. The QPAM Exemption permits the transaction to occur, again assuming that the broker-dealer is neither the QPAM nor an affiliate of the QPAM, nor does it possess the power to hire or fire the QPAM. As another example of the usefulness of the QPAM Exemption, it has become common for a hedge fund of funds to borrow from a bank on a short-term basis to fund investments and redemptions. Just as the QPAM Exemption permits extensions of credit in connection with trading on margin and short sales, so it permits extensions of credit in such situations, even if the bank is otherwise a party in interest to a benefit plan investor in the plan asset look-through hedge fund of funds.

On Aug. 23, 2005, the DOL adopted significant changes to the QPAM Exemption.[37] The revised exemption narrows the definition of who is an affiliate of the entity that has the power to hire and fire the QPAM. Moreover, the revised exemption completely removes the prohibition against the QPAM dealing with a party in interest that has the power to hire and fire the QPAM if the QPAM is managing a plan asset look-through pooled investment vehicle in which at least two unrelated ERISA-covered plans invest. The only exception to this liberalization arises if the counterparty to a transaction had the power to cause a plan to invest in the plan asset look-through pooled investment vehicle and that plan holds 10 percent or more of the equity in the pooled investment vehicle. The DOL has opined that if the ABC plan invests in a plan asset look-through

[35] By executing the securities transactions of a plan asset look-through hedge fund, the broker-dealer becomes a party in interest (as a service provider) to each benefit plan investor in the hedge fund. Because the broker-dealer is a service provider, the extension of credit violates Section 406(a)(1)(B) of ERISA.

[36] While providing exemptive relief from the prohibition against extensions of credit, the purchase of securities on margin and the existence of margin debt in short-sale transactions may cause income derived from these investments to be deemed to be "debt financed income" subject to the unrelated business income tax under Sections 512 and 514 of the Code. Accordingly, an investment adviser should seek assurance from the investing plan that no governing plan documents specifically prohibit investments that could subject the plan to the unrelated business income tax.

[37] 70 Fed. Reg. 49305 (Aug. 23, 2005).

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hedge fund through several funds of funds, or through a combination of a direct investment and an indirect investment through a fund of funds, ABC plan's direct and indirect investments in the underlying hedge fund are not aggregated for purposes of determining whether ABC plan owns 10 percent or more of the equity in the underlying plan asset look-through hedge fund.

There are three types of transactions specifically enumerated in the QPAM Exemption for which the QPAM Exemption does not provide relief. For a plan asset look-through hedge fund, the most important of these transactions is securities lending. If the borrower of the securities is a party in interest with respect to any benefit plan investor in a plan asset look-through hedge fund, the loan of securities will violate Section 406(a)(1)(b) of ERISA. Although the QPAM Exemption does not provide relief for such transactions, a separate class exemption, Prohibited Transaction Exemption 2006-16[38] for securities lending, and the statutory exemption for dealings with "remote" parties in interest set forth in Section 408(b)(17) of ERISA (discussed in Section V of this outline), provide sufficient relief to allow the investment manager of a plan asset look-through hedge fund to engage in securities lending on behalf of the fund. Although not mentioned in the QPAM Exemption, in the preamble to Prohibited Transaction Exemption 2006-16, the DOL raised a question as to whether repurchase agreements were not structurally the same as securities loans.[39] Although not providing a definitive answer, the DOL's discussion of this issue has led a number of investment managers of plan asset look-through hedge funds and their counterparties to conclude that the QPAM Exemption may not permit repurchase agreements between the fund and the counterparty. Instead, the parties to the transaction will often rely on the statutory exemption for dealings with "remote" parties in interest set forth in Section 408(b)(17) of ERISA (discussed in Section V of this outline).

V. General Exemption for Transactions with Service Providers

As part of the Pension Protection Act of 2006, Congress recognized that the prohibited transaction rules were in need of modernization, particularly in light of consolidation in the financial services industry and the very broad definition of the term "party in interest." This broad definition has had the effect of preventing many otherwise beneficial transactions between plans and parties in interest to such plans that have no particular influence over the investment decisions of a plan fiduciary. Accordingly, the Pension Protection Act added Section 408(b)(17) of ERISA,[40] a new statutory exemption that permits a fiduciary with respect to a plan to cause the plan to enter into an otherwise prohibited: (1) sale, exchange or lease of property; (2) loans including a margin loan; or (3) transfer to, or use by a party in interest of, any plan assets, with a party in interest. Section 408(b)(17) of ERISA sets forth two conditions to the very broad relief provided thereunder. First, the party in interest dealing with the plan cannot be a fiduciary with respect to the investment of the plan assets involved in the transaction. Second, the plan must receive no less, nor pay no more, than adequate consideration with respect to the transaction.

In the case of a security traded on a national exchange, Section 408(b)(17) of ERISA defines adequate consideration as the price on the exchange taking into account factors such as size of the transaction and marketability of the security. In the case of a security that is not traded on a national exchange, Section 408(b)(17) of ERISA defines adequate consideration as a price not less favorable than the offering price for the security as established by the current bid and ask quotes of a party independent of the issuer and the party in interest to the transaction, again taking into account factors such as size of the transaction and marketability of the security. In the case of an asset other than a security for which there is a generally recognized market, Section 408(b)(17) of ERISA defines adequate consideration as the fair market value of the asset as determined in good faith by a fiduciary or fiduciaries in accordance with DOL regulations.

[38] 71 Fed. Reg. 63786 (Oct. 21, 2006).

[39] 71 Fed. Reg. 63786, 63792 (Oct. 21, 2006).

[40] ERISA § 408(b)(17) and parallel Code § 4975(d)(20).

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In the context of a plan asset look-through hedge fund, Section 408(b)(17) of ERISA would permit the investment manager of the fund to enter into transactions with a "party in interest" to a benefit plan investor in the hedge fund as long as the counterparty were not acting in a fiduciary capacity with respect to the particular transaction. Thus, in a typical counterparty transaction relying on the relief provided in Section 408(b)(17) of ERISA, there will be a representation in the documents evidencing the transaction that the counterparty is not a fiduciary to the plan asset look-through hedge fund and its benefit plan investors because the counterparty is not providing the investment manager with advice with respect to the transaction that is being relied upon by the investment manager in consummating the transaction. In theory, the relief provided by Section 408(b)(17) of ERISA should replace the need for the investment manager of a plan asset look-through hedge fund to be a QPAM (but not a registered investment adviser) because it provides very broad relief for the transactions exempted under the QPAM Exemption. However, because this section of ERISA is so new and the DOL has issued no regulations thereunder, most counterparties continue to insist on QPAM representations before they will enter into transactions with a plan asset look-through hedge fund.

VI. Special Prohibited Transaction Concerns That Arise in Managing a Plan Asset Look-Through Hedge Fund

A. Payment of Performance-Based Compensation (Incentive Allocation/Fees)

As a fiduciary, the investment manager of a plan asset look-through hedge fund is generally not permitted to deal with the assets in his own interest, or act on behalf of a party whose interests are adverse to those of the fund. Thus, the investment manager may not cause the fund to pay a performance-based fee (i.e., an incentive allocation or fee) in circumstances in which the investment manager can impact the amount of its fees by its own actions. However, according to applicable DOL advisory opinions,[41] an investment manager may receive performance-based compensation (i.e., receive an incentive fee or allocation) in the following factual situation:

1. The investment manager is registered under the Investment Advisers Act of 1940;

2. The decision to retain the investment manager and to pay the incentive fee is made by each fiduciary of each benefit plan investor, and such fiduciary must be independent of the investment manager;

3. Each benefit plan investor has total assets of at least $50 million;

4. No more than 10 percent of each benefit plan investor's total assets are placed in the fund (i.e., under the control of the investment manager);

5. The investment manager generally invests the fund's assets in securities for which market quotations are readily available, and if market quotations are not readily available (e.g., illiquid securities that are not regularly traded), the securities are valued by a qualified party who is independent of the investment manager and who is selected by the benefit plan investors;

6. The investment manager's services may be terminated on reasonably short notice under the circumstances;

7. The incentive fee arrangement complies with the terms and conditions of Securities and Exchange Commission Rule 205-3 governing performance-based compensation;

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[41] *See* Adv. Op. 86-20A (BDN Advisers Inc.), Adv. Op. 86-21A (Batterymarch Financial Management) and Adv. Op. 89-31A (Alliance Capital Management LP).

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8. The total fees paid to the investment manager do not exceed reasonable compensation for services performed by the investment manager;

9. Securities purchased or sold by the investment manager on behalf of the fund are not securities for which the investment manager (or an affiliate) is a market-maker;

10. The incentive fee is determined based on annual performance, taking into account both realized and unrealized gains and losses, and where the investment manager's services are terminated on a date other than an anniversary date, net profit is determined for the period from the commencement of the preceding full year through the termination date; and

11. Each benefit plan investor's plan fiduciary represents that it fully understands the formula for calculating the incentive fee and the risks associated with such an arrangement.

While the relevance of each of the above facts is open to discussion, two are clearly fundamental. First, the ability of the investment manager to control the amount of its compensation by assigning its own values to the hedge fund's assets could give rise to an act of self-dealing prohibited by Section 406(b)(1) of ERISA. Of course, this would also be true even if the manager is compensated purely on the basis of assets under management. However, the DOL has chosen to focus on manager valuation of the assets only in connection with the payment of performance-based compensation. In order to avoid prohibited transaction issues, the investment manager of a plan asset look-through hedge fund must not set its compensation by setting the value of the fund's securities. That does not necessarily require the fund to hire an independent valuator to determine the value of all of the assets, or even of the non-liquid securities. However, the manager must set forth in advance and in a fully disclosed manner to the benefit plan investors how pricing will be determined from (and by) external sources. The subscription agreement will then serve as the consent of the benefit plan investors to the stated valuation methodology.

Second, the incentive fee must be determined based on performance that takes into account both realized and unrealized gains and losses. In the view of the DOL, taking an incentive allocation on realized gains without taking into account unrealized gains and losses clouds the investment judgment of the investment manager, such that he no longer acts in the sole interest of the benefit plan investors, and gives rise to an act of self-dealing. In the DOL's view, paying on realized gains only provides the investment manager with an incentive to: (1) sell the winners and hold onto the losers; and (2) sell the winners early, in each case in order to generate current fees at the expense of the needs of the ERISA investors.

It should be noted that the factual statement set forth in the advisory opinions that the performance fee is to be measured over a one-year period merely reflects the state of Securities Exchange Commission Rule 205-3 at the time the DOL issued its advisory opinions. This one-year requirement has no independent existence under ERISA, nor is it linked to any of the prohibited transaction provisions of the statute. Similarly, neither the requirement that a plan investing in an entity that will pay performance-based compensation have assets of at least $50 million, nor the requirement that the plan have no more than 10 percent of its assets managed by a manager receiving performance-based compensation, have any independent existence under ERISA, nor are they linked to any of the prohibited transaction provisions of the statute. They are merely facts regurgitated by the DOL from the submissions received from the parties requesting the advisory opinions. However, it is clear that the independent plan fiduciary making the decision to invest in the hedge fund must have the sophistication necessary to make a meaningful determination that the investment is in the best interests of the plan he represents.

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B. Employer Securities

ERISA restricts the ability of a benefit plan investor to hold securities issued by the sponsoring employer (or any affiliate of the sponsoring employer) of any benefit plan investor ("employer securities").[42] Accordingly, the investment manager of a plan asset look-through hedge fund may desire to restrict the acquisition of employer securities. Thus, if, for example, the XYZ Pension Plan is an investor in a plan asset look-through hedge fund, the investment manager of the fund should consider restricting the purchase of XYZ stock or debt. In the absence of a self-imposed prohibition, a plan asset look-through hedge fund could acquire "qualifying employer securities"[43] if the value of the qualifying employer securities (when combined with "qualifying employer real property") held by the benefit plan investor does not exceed 10 percent of the value of the benefit plan investor's assets. Each benefit plan investor is considered to have a proportionate interest in each asset of the hedge fund. Thus, if the XYZ Pension Plan's assets equal $100 million, the plan invests 8 percent of its assets directly in XYZ stock and acquires 5 percent of the hedge fund, a violation of ERISA would occur if the hedge fund acquires more than $40 million of XYZ stock because the XYZ Pension Plan will be deemed to have invested 10 percent of its assets in the XYZ stock (i.e., 8 percent directly and 2 percent indirectly through its investment in the hedge fund).

Unless a plan asset look-through hedge fund is willing to monitor its compliance with the ERISA employer security holding limitations every time it purchases employer securities, either: (1) the hedge fund should not invest in employer securities; or (2) the hedge fund's subscription agreement should provide for an acknowledgement by the fiduciary of the benefit plan investor that the investment manager is not taking on responsibility for monitoring compliance with the plan's ERISA restrictions imposed on the acquisition and holding of employer securities, and acknowledging that this is the responsibility of the subscribing fiduciary. The investment manager may also wish to include an indemnity with respect to this acknowledgement from the fiduciary acting on behalf of the benefit plan investor.

C. Investments in Other Entities

If a hedge fund is a plan asset look-through fund of funds, the investment manager will need to determine whether the underlying hedge funds in which it wishes to invest will permit investments from a plan asset look-through entity. If benefit plan investors own 25 percent or more of any class of equity interests in an underlying fund that accepts investments from such a plan asset look-through fund of funds, then such underlying hedge fund would be a plan asset look-through hedge fund subject to all of the rules discussed in this outline. Further, in such a situation, the investment manager of the fund of funds steps into the shoes of the plan trustees with respect to its responsibility to invest the assets of the hedge fund of funds. Thus, if the manager of the underlying hedge fund was not a registered investment adviser, the manager of the investing plan asset look-through hedge fund of funds would be liable for each of the investment decisions of the manager of the underlying plan asset look-through hedge fund.

On the other hand, just as a trustee sheds its responsibilities for the day-to-day investment of plan assets by hiring a registered investment adviser to manage the plan assets, so the investment manager of a plan asset look-through hedge fund of funds can shed its investment responsibilities for the

[42] ERISA §§ 406(a)(1)(E), 406(a)(2), 407(a).

[43] A "qualifying employer security" includes both stock and marketable obligations of the benefit plan investor's sponsoring employer, provided that no more than 25 percent of the outstanding stock or marketable obligations at the time of acquisition is held by the benefit plan investor, at least 50 percent of the outstanding stock or marketable obligations is held by persons independent of the sponsoring employer, and, in the case of marketable obligations, immediately following the acquisition, no more than 25 percent of the benefit plan investor's assets are invested in marketable obligations of the sponsoring employer.

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investment of the assets in an underlying plan asset look-through underlying fund. In order to shed these responsibilities, the investment manager of a plan asset look-through hedge fund of funds should be appointed by the ERISA plans investing in the hedge fund of funds as a "named fiduciary" (within the meaning of Section 402 of ERISA) of each of such ERISA plans, for the limited purpose of investing in underlying plan asset look-through hedge funds. Of course, the investment manager of any underlying plan asset look-through hedge fund must also be a registered investment adviser, or the delegation will be ineffective. (See the discussion in part A of Section III of this outline.)

VII. Increasing ERISA Capacity While Trying to Avoid Plan Asset Look-Through Status: "The Hard Wired Feeder Concept"

ERISA-covered pension plan investors are a growing source of assets flowing into hedge funds. While many corporations have frozen their traditional defined benefit pension plans (i.e., no new benefits are accruing under the plan), those plans still have billions of investible assets, and investment time horizons of 20 to 40 years. Further, many of these plans are underfunded as a result of the recession of 2008 and the resulting low interest rates. Thus, internal corporate pension plan managers are seeking to invest more assets in alternative vehicles in the hopes of obtaining higher investment returns than those available from traditional asset classes, such as fixed income. At the same time, some hedge funds are facing redemptions from non-pension investors rebalancing portfolios or still addressing liquidity needs, while their pension investors have often remained invested in such funds. The convergence of these two factors is leading some hedge funds to approach the 25-percent limitation on benefit plan investors' investment in the fund. Accordingly, many managers are looking for ways in which to increase ERISA capacity without subjecting their hedge fund to the fiduciary responsibility provisions of ERISA.

A common approach to providing expanded ERISA capacity while at the same time avoiding subjecting the hedge fund and its manager to the fiduciary responsibility provisions of ERISA involves restructuring an existing master-feeder structure, or establishing a new master-feeder structure in place of existing arrangements. In this scenario, each feeder into the master fund is "hard wired" into the master fund. Thus, all of the investible assets of each of the feeder funds are invested in the master fund, which makes all of the investments. None of the feeders make their own investments. The feeder funds may maintain a minimal amount of cash to pay expenses, but in many cases the feeder funds do not even do that. Rather, a feeder fund will receive distributions from the master fund every time it has an expense to pay (which typically is not that often given the minimal role played by the feeder funds). The offering memorandum for the feeder funds will often refer to them as mere conduits into the master fund and will specifically state that the feeder funds are not making their own independent investments.

The "hard wired" master-feeder structure assumes that there is only one class of equity interests at the master fund (although sometimes there is a second class that holds the investments by the manager or its affiliates). After restructuring or establishing a "hard wired" master-feeder structure, an offshore feeder fund will often have one or more classes of equity interests exceeding the 25-percent limitation on investment by benefit plan investors. However, the master fund, where the capital from all of the feeder funds is aggregated, will be under 25 percent plan assets. Thus, even though the offshore feeder fund is a benefit plan investor, only a portion of its investment in the master fund is counted as benefit plan investor capital. At the onshore feeder fund, little if any investment will have come from benefit plan investors. Thus, no part of the onshore feeder fund's investment in the master mund is counted as benefit plan investor capital. When properly structured, the non-benefit plan investor capital from the offshore and onshore feeder funds will exceed 75 percent of the capital in the only class of shares of the master fund, and thus neither the master fund nor its investment manager are subject to ERISA.

The position taken at the offshore feeder fund is that while the offshore feeder fund is a plan asset look-through vehicle, the "manager" of the offshore feeder fund is not acting as an ERISA fiduciary when it

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invests the assets from the offshore feeder fund into the master fund. Further, there is nothing other than ministerial actions for the "manager" of the offshore feeder fund to undertake in connection with the management of the offshore feeder fund. Thus, in our view, the "manager" of the offshore feeder fund is not acting as an ERISA fiduciary of the investing benefit plan investors for any reason. Accordingly, there is no need to appoint the "manager" of the offshore feeder fund as an "investment manager" within the meaning of Section 3(38) of ERISA with respect to the ERISA plans investing in the offshore feeder fund. Although this position has been endorsed by many practitioners, there is no authority on point, and we are aware of no "hard wired" master-feeder fund structure that provides for the investing benefit plan investors to appoint the "manager" of the offshore feeder fund as their "investment manager" within the meaning of Section 3(38) of ERISA.

The principal downside to the "hard wired" master-feeder structure is that it eliminates the flexibility to invest at the feeder fund level. Thus, this structure will not be appropriate for all investment strategies given the tax and regulatory issues connected with certain investments (e.g., ECI and FIRPTA). Among the items that need to be considered and actions that need to be taken to convert an already existing master-feeder structure into a "hard wired" master-feeder structure are the following:

A. Review the hedge fund's current investment program to determine if all of the investments can be made at the master fund level.

B. Review the hedge fund's existing and prior investments to determine if all are or were at the master fund level, or if some are or were at the feeder fund level.

C. If there are or were feeder fund level investments, determine if all those investments could have been made at the master fund level (or can be transferred to the master fund in the case of existing feeder fund investments).

D. Determine if the hard wiring of the feeder funds constitutes a material change in the investment program.

E. If hard wiring gives rise to a material change in the investment program, determine if investor consent, or redemption right, will be necessary.

F. Review the master fund to determine how many classes of shares exist at the master fund, and if there are multiple classes at the master fund level, determine if they can be merged.

G. Contact the ERISA investors to inform them of the proposed hard wiring and discuss any issues they may have with such a structure.

H. Review the offering memorandum for each of the feeder funds and determine the revisions necessary to reflect the hard wiring and the position that the "manager" of the offshore feeder fund is not acting as an ERISA fiduciary to the ERISA investors by investing the assets of the offshore feeder fund into the master fund.

I. Revise the investment management agreements for the feeder funds to reflect the hard wiring, stripping the agreements of all language that suggests discretionary investing at the feeder fund level.

J. Revise the limited partnership agreement of the onshore feeder fund to reflect the hard wiring, stripping the agreements of all language that suggests discretionary investing at the onshore feeder fund level.

K. Send a letter to the ERISA investors in the offshore feeder fund stating that the investment manager is not acting as an ERISA fiduciary in investing the assets of the offshore feeder fund into the master fund

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and obtain consent to the statement that the fiduciaries of the ERISA investors will never assert a position to the contrary.

L. Amend subscription agreements to include the statement that the investment manager is not acting as an ERISA fiduciary in investing the assets of the offshore feeder fund into the master fund and obtain consent to the statement that the fiduciaries of the ERISA investors will never assert a position to the contrary.

M. Address the need for the offshore feeder fund to obtain an ERISA fidelity bond covering each of the ERISA investors or provide for the ERISA investors to cover the "manager" of the feeder fund on an agent's rider to the ERISA investor's own fidelity bond.

As a general rule, we have found little or no resistance to the conversion of an existing master-feeder structure into a hard wired master-feeder structure and allowing the offshore feeder fund to exceed the 25-percent limit as long as the master fund is kept under 25 percent plan assets. However, there are two issues that do arise from ERISA investors. First, certain funds of funds that are benefit plan investors have promised their ERISA investors that the fund of funds would not invest in a plan asset fund. Many of those funds of funds have accepted that investing in a "hard wired" master-feeder structure in which the master fund is not a plan asset vehicle complies with the fund of funds' promise to its ERISA investors, though not all. In those situations where a fund of funds that is a benefit plan investor is not willing to invest in a "hard wired" offshore feeder fund that is over 25 percent plan assets, we recommend that an ERISA-only offshore feeder fund be set up to accommodate the existing ERISA investors that are willing to make the switch as well as for new ERISA investors. Those ERISA investors that state that they may not invest in a plan asset vehicle would remain in the original offshore feeder fund, which continues to be below the 25-percent ERISA threshold and thus is not a plan asset vehicle. A second issue that arises from ERISA investors involves the fidelity bond mandated by ERISA for anyone who "handles" pension money. Whether the "manager" of the offshore feeder fund needs to obtain the fidelity bond and who pays for the bond are the subject of negotiation. ERISA would permit the ERISA investor to cover the "manager" of the offshore feeder fund as an agent on the ERISA investor's own fidelity bond, but plans and funds of funds that are themselves benefit plan investors are sometimes resistant to doing this. If the "manager" of the offshore feeder fund agrees to obtain the fidelity bond, ERISA would permit the offshore feeder fund to pay the premium, but here, too, resistance is sometimes encountered from ERISA plans and other benefit plan investors.

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Appendix A

Consequences of Violating the Fiduciary and Prohibited Transaction Provisions of ERISA

I. ERISA

A fiduciary that breaches any of the standards of fiduciary conduct imposed by ERISA is personally liable to make good to the plan any losses to the plan resulting from the breach and to restore to the plan any profits of the fiduciary arising from the fiduciary's use of plan assets. Making good the plan's losses requires that the breaching fiduciary both restore any investment losses and provide to the plan an amount equal to the income the plan would have earned had there been no fiduciary breach. That amount is typically determined based on the rate of return on the other assets of the plan and by determining how the assets committed as a result of the breach would otherwise have been invested. The fiduciary may also be removed by a court for violation of his fiduciary responsibilities and may be subject to any other relief that the court deems appropriate.[44]

NOTE: In order for a fiduciary to incur any liability under ERISA with respect to a prohibited transaction, he must have known or should have known that the transaction was in one of the prohibited categories described in part E(2) of Section I of this outline.[45] Therefore, transactions with a party in interest where the fiduciary does not know that such party is a party in interest will not subject the fiduciary to liability unless its lack of knowledge was due to its failure to discharge its fiduciary obligations in a prudent manner. For example, a purchase from or sale of a plan asset to a party in interest will not be a prohibited transaction if the transaction is an ordinary "blind" purchase or sale of securities through an exchange where neither buyer nor seller (nor the agent of either) knows the identity of the other party involved.[46]

Section 502(1) of ERISA requires the DOL to impose a civil penalty against a fiduciary who commits a fiduciary breach (including a prohibited transaction) equal to 20 percent of the amount recovered by the DOL pursuant to a settlement agreement with the DOL or pursuant to a court order in a judicial proceeding instituted by the DOL. Section 502(1) requires that a similar penalty be assessed against any non-fiduciary who knowingly participates in such a breach. The DOL has the authority to waive or reduce the penalty if the DOL determines that the fiduciary or non-fiduciary acted in good faith or if imposing the penalty would cause a severe financial hardship.

II. Internal Revenue Code

A. Tax Imposed

The Code imposes a tax on a disqualified person who participates in a prohibited transaction. The initial tax is 15 percent of the greater of the fair market value of the consideration given or the fair market value of the consideration received in the transaction.[47] However, if the prohibited transaction involves the receipt of excess compensation for the performance of services, the initial tax is 15 percent of the excess compensation. The tax is payable for every year beginning with the year in which the transaction occurs and ending with the year in which occurs the earlier of:

1. The mailing date of a notice of deficiency (90-day letter) to the taxpayer; or
2. The date on which the initial excise tax is assessed; or

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[44] ERISA § 409(a).

[45] ERISA § 406.

[46] Conf. Rept. 93-1280, 1974-3 C.B. 415, 468.

[47] Code § 4975(a) and (f)(4).

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3. The "correction date," i.e., the date the transaction is undone to the extent possible, and in any case, the date on which the plan is placed in a financial position not worse than it would have been if the party in interest were acting under the highest fiduciary standards.[48]

If the correction date does not occur prior to 90 days after the mailing of a notice of deficiency (unless: (1) the taxpayer challenges the tax in the Tax Court; or (2) the IRS extends the permissible period in which the transaction may be corrected), there is an additional tax of 100 percent of the consideration given or received or the consideration in excess of reasonable compensation, whichever is applicable,[49] and the amount on which the tax is based may be increased.[50] Section 4975(d)(23) of the Code together with Section 4975(f)(11) of the Code provide an exemption from the prohibited transaction excise tax if a disqualified person enters into a prohibited transaction with the plan as long as he did not know (or should not reasonably have known) that the transaction was a prohibited transaction and if the prohibited transaction is corrected during a correction period. The statute defines the correction period as a 14-day period that begins on the date that the disqualified person discovers, or reasonably should have discovered, that the particular transaction was a prohibited transaction. Correction is defined as undoing the transaction to the extent possible and in any case making good to the plan any losses it suffered as a result of the prohibited transaction, and restoring to the plan any profits made by the disqualified person through the use of the plan's assets.[51]

B. Liability for the Tax

The tax is imposed on any party in interest who participates in the transaction (other than a fiduciary acting only as such). Generally, the tax is imposed without regard to whether or not the party in interest was aware that he was participating in a prohibited transaction.[52] If more than one person is liable for the tax, the tax is the joint and several liability of all such persons.[53] However, if a plan fiduciary participates in a prohibited transaction solely in his capacity as a fiduciary, he is not liable for the tax.[54] In addition, engaging in a prohibited transaction generally will not result in disqualification of a plan.

In the case of a non-qualified plan (i.e., a plan not covered by the prohibited transaction provision of the Code), the DOL can impose a penalty on a party in interest with respect to prohibited transactions similar to the tax described above, and Section 408(b)(20) provides an exemption from the tax if the prohibited transaction is corrected that parallels the provisions discussed above in connection with Sections 4975(d)(20) and 4975(f)(11) of the Code.[55]

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[48] Code § 4975(a), (f)(2) and (f)(5).

[49] Code § 4975(b) and (f)(6).

[50] Code § 4975(f)(4)(B).

[51] Code § 4975(d)(31) and (f)(11).

[52] Code § 4975(a) and (b).

[53] Code § 4975(f)(1).

[54] Code § 4975(a) and (b).

[55] ERISA §§ 502(i) and 408(b)(20).

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Appendix B

Benefit Plan Investors

A. U.S. private pension plans

B. U.S. private 401(k)/profit sharing plans

C. U.S. private health and welfare plans (medical plans, life insurance plans, vacation plans, etc.)

D. Keogh plans

E. Church plans that have elected to be covered by Title I of ERISA

F. Certain life insurance company general and separate accounts

G. Individual retirement accounts (traditional, Roth, SEP-IRAs, SIMPLE IRAs, etc.)

H. Group trusts qualified under Revenue Ruling 81-100

I. Entities that are treated under ERISA as holding plan assets (e.g., a fund of funds)

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