

ERISA Considerations: What Fund Managers Need to Know

The following discussion provides a general overview of how an investment company or partnership (hereinafter, a “fund”) and its principal investment manager may be impacted upon the acceptance of investor capital contributions (collectively, “benefit plan investors”), which are generally subject to the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), and parallel requirements in the Internal Revenue Code, as amended (“IRC”). The provisions of ERISA and the IRC are subject to oversight by the U.S. Department of Labor (the “DOL”) and the Internal Revenue Service, respectively.

The Purpose behind ERISA

ERISA is a complex piece of legislation enacted to regulate the establishment, operation, and administration of employee benefit plans (“benefit plans”) as a means of protecting the intended beneficiaries of such benefit plans from abuses associated with imprudent investing and other problems, such as unfunded plans. To achieve its objective, ERISA imposes numerous obligations on fiduciaries of benefit plans and prohibits certain transactions involving conflicts of interests (the so-called “prohibited transactions”).

When Does ERISA Apply to my Fund?

The ERISA provisions apply to a fund when two conditions are met: 1) benefit plan investors (defined below) are considered to hold a “significant” amount of the fund’s equity interest, and 2) at least one of those investors, no matter the size of their investment, is an employee welfare or pension benefit plan (defined below). Benefit plan investors are considered to hold a significant amount of a fund’s equity interest if they hold, in the aggregate, 25% or more of the value of any class of the fund’s equity interests (e.g., limited partnership interests).

When Does ERISA *Not* Apply to my Fund?

The ERISA provisions will not apply to a fund when benefit plan investors hold, in the aggregate, less than 25% of the value of any class of the fund’s equity interests or when there are no employee welfare or pension benefit plans invested in the fund. However, the so-called “prohibited transactions” restrictions under the IRC (described below) will nonetheless apply if only one condition is met: benefit plan investors (defined below) are considered to hold a “significant” amount of the fund’s equity interest (i.e., the 25% threshold is met).

Who are “Benefit Plan Investors”?

Generally speaking, benefit plan investors include 1) employee benefit plans which are subject to ERISA, 2) plans to which IRC Section 4975 applies, and 3) entities whose underlying assets include “plan assets.”

For Further Information:

- 1) Employee benefit plans subject to ERISA include both “employee welfare benefit plans” and “employee pension benefit plans.” Employee welfare benefit plans are defined in ERISA Section 3(1) and generally include those plans which provide:
- a. Medical, surgical, or hospital care or benefits, including, but not limited to, major medical, dental, vision, and prescription drug benefits; healthcare flexible spending accounts (Health FSAs); health reimbursement arrangements (HRAs), including premium reimbursement plans; and certain employee assistance programs (EAPs), wellness programs, disease-management programs, and cancer policies;
 - b. Benefits in the event of sickness, accident, death, or unemployment, including insured disability income plans, insured sick-pay plans, accidental death and dismemberment (AD&D) plans, and life insurance plans;
 - c. Funded vacation benefits;
 - d. Funded apprenticeship or training benefits;
 - e. Day-care centers;
 - f. Funded scholarship benefits;
 - g. Certain prepaid legal service arrangements;
 - h. Severance and holiday benefits; and
 - i. Certain housing assistance benefits.

Employee pension benefit plans are defined in ERISA Section 3(2) and generally include:

- a. Defined benefit pension plans funded by an employer and guaranteeing a retirement benefit to the employee based on a number of factors, including his/her age, salary, and length of service; and
- b. Defined contribution pension plans, such as money purchase plans, profit sharing plans or stock bonus plans, employee stock ownership plans (ESOPs), Taft-Hartley plans, and 401(k) plans.

Notably, certain plans are not covered by ERISA unless such plans explicitly opt in, including:

- a. Federal, state, or local government plans or plans of certain international organizations;
- b. Church or church association plans;
- c. Plans maintained solely to comply with state worker’s compensation, unemployment, compensation, or disability insurance laws;
- d. Plans maintained outside the United States primarily for the benefit of non-resident aliens;

For Further Information:

- e. Certain private employer plans, commonly known as “top hat” plans, which provide deferred compensation to a limited number of management or other highly compensated employees; and
 - f. Unfunded excess benefit plans, or plans maintained solely to provide benefits or contributions in excess of those allowable for tax-qualified plans.
- 2) IRC Section 4975 applies to the plans described in subsection 4975(e)(1) of the Code, including:
- a. Individual retirement accounts (IRAs);
 - b. Individual retirement annuities;
 - c. Keogh plans;
 - d. Health savings accounts (HSAs); and
 - e. Tax-exempt trusts.
- 3) Entities may also be benefit plan investors if their underlying assets are plan assets. Commonly, this may occur in a fund of funds situation: if a fund of funds has an equity class, 25% or more of which is held by benefit plan investors, that fund of funds is a benefit plan investor in each of the funds in which it invests (limited to the percentage of which the fund of funds’ underlying assets are plan assets). For example, a fund of funds has one equity class of which 50% is held by benefit plan investors, making the fund of funds’ underlying assets “plan assets.” The fund of funds then invests \$1 million in another fund, and is therefore considered a benefit plan investor in the amount of \$500,000 (50% of the \$1 million investment). This investment by the fund of funds may, in turn, trigger the 25% ERISA threshold for the fund in which it invests (see below).

Monitoring the 25% Benefit Plan Investor Threshold

To remain outside from the purview of ERISA and from the “prohibited transactions” restriction, a fund must ensure that its benefit plan investors do not hold 25% of any class of its equity interests at any moment.

Class Distinctions- although the law remains vague on this point, it is advisable that the 25% threshold be observed for all classes of interests or shares in your fund (ie, Class A, Class B, etc.), even if there is no material difference between the classes. On the other hand, even if all the interests or shares of your fund belong to the same class, differences among investors or the series of interests or shares they hold may trigger the “class of equity” distinction. For example, a benefit plan investor signs a side letter agreement with the fund changing one or more of the material terms of the offering, though no new “class” of shares is created; nevertheless, this side letter may create a new *de facto* class of equity interests and violate the 25% threshold, triggering ERISA and/or the “prohibited transactions” restriction.

For Further Information:

Fund of Funds- if a fund of funds is a benefit plan investor (see above), only that percentage of the fund of funds' investment in another fund which is attributable to benefit plan investors is counted toward the second fund's 25% threshold. Furthermore, if a fund of funds has benefit plan investors but does not meet the 25% threshold, then the fund of funds' investment in another fund is treated entirely as non-benefit plan investor assets. For example, if a fund of funds has a single class of equity interests, 30% of which is held by benefit plan investors, then 30% of any investment it makes in another fund is treated as plan assets; however, if a fund of funds has a single class of equity interests, 20% of which is held by benefit plan investors, then *none* of the investments it makes in other funds are treated as plan assets.

Insider Benefit Plan Investors- Notwithstanding the General Partner, Investment Adviser, or their respective employees or officers are benefit plan investors according to the definitions provided above, investments by these entities and individuals do not count towards the 25% threshold.

Withdrawals can Trigger the 25% Threshold- Not only must fund managers calculate whether any particular contribution to their fund will violate the 25% threshold, but also whether any withdrawal of non-benefit plan investors will cause the threshold to be met. To provide for this exigency, most funds allow for mandatory withdrawals on relatively short notice.

What Happens if the 25% Threshold is Met?

If ERISA were to apply to your fund, it would likely impact your management of the fund in a myriad of ways, including:

Heightened Fiduciary Standards- under ERISA, a fund's manager who renders investment advice for compensation is a fiduciary to all benefit plan investors. As a fiduciary, the manager owes a duty of loyalty, must adhere to the statutory "prudent man" standard¹ with regard to investments made on the fund's behalf, diversify the fund's investments to minimize the risk of large losses, and abide by the documents governing the plan itself.

Restrictions on Performance Fees- though not prohibited per se, the valuation of illiquid assets for performance fee purposes makes charging such fees complicated and subject to strict rules.

No Soft Dollars- ERISA absolutely prohibits the use of "soft dollars" in connection with a fund's brokerage services, which would otherwise be within the safe harbor of Section 28(e) of the Securities Act of 1934.

Cross Trades Restrictions- ERISA places various restrictions on cross trades between funds controlled by a single manager.

¹ 29 U.S.C. § 1104(a)(1)(B).

For Further Information:

Limited Custody of Foreign Assets- ERISA limits the entities qualified to hold plan assets outside of the United States.

Limited Investment in Employer Securities- to comply with ERISA's limitations on investing in an employer's securities, a fund manager must monitor the fund's ownership levels in companies whose pension plans have invested in the fund.

Limits on Amortizing Organizational Expenses- ERISA limits the organizational expenses that can be borne by a fund holding plan assets.

Indemnification Restrictions- ERISA does not allow for the indemnification of managers for negligence and may impose other restrictions on the indemnification of the manager of a fund holding plan assets.

Mandatory Fidelity Bonding- ERISA requires that all plan fiduciaries, which would include the manager of a fund holding plan assets, hold appropriate fidelity bond coverage.

Increased Reporting- because pension plans must file certain periodic reports with the DOL, these investors may require more extensive and in-depth reporting of information from the fund manager.

Prohibited Transactions Restrictions*- the manager of a fund holding plan assets is restricted from entering into certain "prohibited transactions" with a "party in interest" to the plan(s) which are invested in the fund. A party in interest includes any fiduciary to a plan, any person providing services to a plan, an employer whose employees are covered by a plan, a union or other employee organization whose members are covered by a plan, the owner of a 50% or greater interest in the employer, union, or other employee organization, and an entity 50% or more of which is owned, directly or indirectly, by individuals or entities included in any of the above categories, among others. Prohibited transactions include activities that would involve self-dealing on the part of the fiduciary, including handling plan assets for the fiduciary's or a party in interest's own benefit or account or receiving compensation from a party dealing with the plan in connection with a transaction involving the plan. In addition, certain specified transactions between a party in interest and a plan, such as loans, the sale, exchange, or lease of property, or the transfer to, or use by, a party in interest of plan assets, are prohibited.

*As noted above, even if ERISA were not to apply to your fund, the "prohibited transactions" restrictions under the IRC described above would nevertheless apply if the benefit plan investors reach the 25% threshold.

This Memorandum is intended to inform Malik Law Group's clients of certain legal matters and is not intended as legal advice. You should consult a lawyer before taking any action based on the information contained above. Please contact Malik Law Group with any questions or comments you may have about this Memorandum.

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