New Pension Bill Will Amend ERISA's "Plan Assets" Definition and Add Prohibited Transaction Exemptions[+]

By Jacob I. Friedman,[*] Ira G. Bogner,[*] and Jeffrey Ross[*]

* *Jacob I. Friedman is the Chair of Proskauer Rose's Tax Department. In recent years, his major areas of practice have been the structuring of alternative investments for pension trusts and other exempt organizations, and the rendering of fiduciary advice to ERISA trustees. Ira G. Bogner is a partner in Proskauer Rose's Employee Benefits and Executive Compensation Group. Ira frequently is called on to structure and analyze alternative investments for pension trusts and other exempt organizations. Jeffrey Ross is an associate in Proskauer Rose's Employee Benefits and Executive Compensation Law Practice Group. Jeffrey assists alternative investment funds in navigating ERISA's fiduciary and prohibited transaction rules and its regulation regarding "plan assets." He also represents pension plans as investors in alternative investment funds.*

Introduction

On August 17, 2006, President Bush signed the Pension Protection Act of 2006.[1] The Act, which significantly amends many provisions of the Employee Retirement Income Security Act of 1974 ("ERISA"), as amended, and the related provisions of the Internal Revenue Code of 1986 (the "Code"), as amended,[2] has received considerable media attention for its pension funding and cash balance provisions. However, the Act also revises several fiduciary and prohibited transaction rules governing the investment activity of ERISA-covered plans. Among other changes, the Act amends ERISA's "plan assets" definition and creates several new exemptions from ERISA's prohibited transaction rules that will simplify many financial transactions for ERISA-covered plans and their counterparties. This article describes these investment-related provisions exclusively.

Unless otherwise specified below, these provisions became effective on the date of enactment (August 17, 2006).

Plan Assets and the 25% Test

Background

A current Department of Labor regulation (the "Plan Assets Regulation")[3] governs when assets held by an entity will be treated as held directly by the entity's investors that are covered by Title I of ERISA and Section 4975 of the Code. Under the Plan Assets Regulation, if a plan invests in an entity, the plan's assets include its investment, but do not necessarily include any of the underlying assets of the entity. However, in the case of a plan's investment in an "equity interest" of an entity that is neither a "publicly-offered security" nor a mutual fund, its assets may include both the equity interest and an undivided interest in each of the underlying assets of the entity. This is sometimes referred to as the "Look-Through Rule."

The Look-Through Rule does not apply, however, to investments in certain "operating companies"[4] or if equity participation in an entity by "benefit plan investors" is not "significant."[5] In general, equity participation by "benefit plan investors" is "significant" on any date if, immediately after the most recent acquisition of any equity interest in the entity, 25% or more of the value (in the aggregate) of any class of equity interests in the entity is held by "benefit plan investors" (this is commonly known as the "25% Test").[6]

Pending Changes

The Act amends several aspects of the Plan Assets Regulation's 25% Test. First, the Act revises the definition of "benefit plan investor." As amended, the term "benefit plan investor" will include only (i) plans subject to Part 4 of Title I of ERISA, (ii) plans subject to Section 4975 of the Code, and (iii) entities that are deemed to hold the assets of these plans under the Plan Assets Regulation.[7] Before these changes, all benefit plans were included in this definition, regardless of whether they were subject to ERISA or the Code. Thus, for example, government employee plans,

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1 Pub. L. No. 109-280, 120 Stat. 780.

2 References to ERISA include the corresponding provisions of the Code and references to ERISA-covered plans also refer to plans covered by Section 4975 of the Code.

3 29 C.F.R. § 2510.3-101.

4 29 C.F.R. § 2510.3-101(a)(2)(i).

5 29 C.F.R. § 2510.3-101(a)(2)(ii).

6 29 C.F.R. § 2510.3-101(f).

7 Pension Protection Act of 2006, Section 611(f).

foreign plans, non-electing church plans, and excess benefit plans were all previously included in the "numerator" of the 25% Test, but now will no longer be included.

The Act further provides that when one entity which holds "plan assets" invests in a second entity, only the portion of the investing entity's equity interests actually held by benefit plan investors is considered for purposes of applying the 25% Test to the second entity.[8] The new rule will have a significant impact on collective investment funds, such as "hedge funds" and "funds of funds" that can presently avoid the Look-Through Rule only by complying with the 25% Test. The new rule is illustrated by three examples:

Example 1

Fund of Funds A is an investment partnership that invests in private equity funds. Twenty seven percent of the only class of equity interest in Fund of Funds A is owned by government employee, foreign and ERISA-covered plans. However, only ten percent of Fund of Funds A is owned by ERISA-covered plans. Currently, the Look-Through Rule applies to Fund of Funds A. But under the Act, the Look-Through Rule will no longer apply to Fund of Funds A.

Example 2

Fund of Funds B is an investment partnership that invests in other hedge funds. Sixty percent of the equity interests in Fund of Funds B is held by ERISA-covered plans. If Fund of Funds B invests $1,000,000 in Hedge Fund C, then under the Act, Hedge Fund C must count only $600,000 of Fund of Fund B's investment as an investment by a "benefit plan investor." If Hedge Fund C has $2,500,000 in investments from other investors that are not benefit plan investors, the Look-Through Rule would not apply to Hedge Fund C under the Act, because participation of benefit plan investors is only about 17% ($600,000 / $3.5 million). (Under a literal interpretation of the Plan Assets Regulation before the Act, Fund of Fund B's entire $1,000,000 investment would have counted in applying the 25% Test to Hedge Fund C, leaving Hedge Fund C subject to the Look-Through Rule with about 28.5% benefit plan investor participation.)

Example 3

Investors must invest in Master Fund Z through either Domestic Feeder Fund X or Off-Shore Feeder Fund Y. Domestic Feeder Fund X holds $5,000,000 in assets, none of which is owned by "benefit plan investors." Off-Shore Feeder Fund Y also holds $5,000,000 in assets, 49% of which (or $2,450,000) is held by "benefit plan investors." Master Fund Z holds $10,000,000 in assets ($5 million from each of its feeder funds). Because only $2,450,000 of Off-Shore Feeder Fund Y's investment is regarded as being owned by a benefit plan investor under the Act, the interest of benefit plan investors in Master Fund Z is only 24.5% ($2,450,000 of $10,000,000). Thus, under the Act, Master Fund Z is not subject to the Look-Through Rule.

Prohibited Transactions

Background

ERISA generally prohibits both "party in interest"[9] and "self-dealing" transactions.[10] The "party in interest" rules generally proscribe, among other things, direct or indirect sales, exchanges, extensions of credit, or the furnishing of goods or services, between a plan and "parties in interest" to the plan, as well as transfers to a party in interest of any assets of a plan.[11] The "self dealing" rules generally prohibit fiduciaries of a plan from dealing with plan assets for their own benefit.[12]

The definition of "party in interest" is very broad and includes, among others, the employer and/or union sponsoring a plan, any service provider to a plan, a plan's fiduciaries and a wide network of entities having certain affiliations with the foregoing entities.[13]

Given the broad scope of the "party in interest" definition and the numerous transactions with these entities that are potentially prohibited, plans have had increasing difficulty engaging in certain common financial transactions, especially in light of recent consolidation in the financial services industry. The exemptions described below should significantly alleviate certain of those difficulties and avoid the need to rely on existing exemptions, such as the exemption for transactions entered into by "qualified professional asset managers."

Exemptions

Transactions with Service Providers

The Act adds an exemption for certain transactions (such as sales of property and transfers or uses of plan assets) between a plan and a service provider to the plan (and the service provider's affiliates) where the plan receives no less, nor pays no more, than

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8 *Id.*

9 References to "parties in interest" under ERISA also refer to "disqualified persons" under the Code.

10 29 U.S.C. § 1106(a), (b); 26 U.S.C. § 4975(c)(1).

11 29 U.S.C. § 1106(a); 26 U.S.C. § 4975(c)(1)(A)-(D).

12 29 U.S.C. § 1106(b); 26 U.S.C. § 4975(c)(1)(E), (F).

13 29 U.S.C. § 1002(14); 26 U.S.C. § 4975(e)(2).

"adequate consideration."[14] If there is a generally recognized market for a security, "adequate consideration" means the security's prevailing price on a national securities exchange.[15] If the security is not traded on a national exchange, "adequate consideration" means a price not less favorable to the plan than the offering price for the security, as established by the current bid and asked prices quoted by persons independent of the issuer and the transacting service provider.[16] In either case, factors such as the size of the transaction and marketability of the security must be taken into account.[17] Finally, for an asset other than a security for which there is a generally recognized market, "adequate consideration" means the fair market value of the asset as determined by a fiduciary of the plan in accordance with forthcoming Department of Labor regulations.[18]

This exemption is not available if the service provider entering into the transaction is a fiduciary or an affiliate of a fiduciary who has or exercises any discretionary authority or control with respect to the investment of the assets involved in the transaction or renders investment advice with respect to the assets involved in the transaction.[19] The exemption is also not available for the furnishing of goods, services, or facilities between a plan and a service provider—although many of these transactions would still be eligible for relief under the Department of Labor's "necessary services" exemption.

Electronic Communications Networks

The Act adds an exemption for certain transactions conducted on electronic communications networks, alternative trading systems and similar trading systems that are federally regulated or subject to certain foreign regulatory entities specified in forthcoming Department of Labor regulations.[20]

The exemption applies to transactions between a plan and a party in interest if:

- the transaction is effected under approved rules that match purchases and sales at the best price available or if neither the execution system nor the parties to the transaction take into account the identity of the transacting parties (i.e., the transaction is "blind");
- the price and compensation associated with the transaction is not greater than that of an arm's length transaction with an unrelated party;
- any transacting party in interest that has an ownership interest in the electronic system has been authorized by the plan's sponsor or other independent fiduciary to engage in such transactions; and
- a plan fiduciary is provided with a written notice of the transaction at least 30 days before the first transaction through the system.[21]

Cross Trading

The Act adds an exemption for certain transactions between a plan and another account managed by the same investment manager (known as a "cross trade") if:

- the transaction is a purchase or sale, for no consideration other than cash payment against prompt delivery of a security for which market quotations are readily available;
- the trade is effected at the independent current market price of the security;
- no commissions or brokers fees are paid (other than disclosed, customary transfer fees);
- a plan fiduciary other than the investment manager directing the trade authorizes the transaction in advance in a separate written agreement after the fiduciary receives a separate written disclosure regarding the investment manager's cross trading policies and procedures; and
- each participating plan has assets of at least $100,000,000.[22]

In addition, for the exemption to apply, the investment manager directing the trade must:

- provide the authorizing plan fiduciary with a quarterly report identifying all cross trades in which the plan participated;
- not base its fee schedule, nor condition the provision of any other service, on the plan's consent to cross trading;

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14 Pension Protection Act of 2006, Section 611(d).

15 *Id.*

16 *Id.*

17 *Id.*

18 *Id.*

19 *Id.*

20 Pension Protection Act of 2006, Section 611(c).

21 *Id.*

22 Pension Protection Act of 2006, Section 611(g).

- adopt written cross trading policies and procedures that are fair and equitable and that include a description of the manager's pricing policy and procedures and the policies and procedures for allocating cross trades; and
- designate an individual who will periodically review the compliance of purchases and sales with the manager's written policies and issue an annual written report, signed under penalty of perjury, within 90 days of the period to which it relates; the report must detail the steps performed during the periodic review, the manager's level of compliance, and instances of non-compliance, as well as notify the plan fiduciary of the plan's right to terminate the cross trading authorization.[23]

The Act directs the Department of Labor to issue regulations within 180 days of the Act's effective date that will specify the content of the policies and procedures required to be adopted by an investment manager.[24]

Block Trading

The Act adds an exemption for certain "block trades" of securities (or other property determined by the Department of Labor) between a plan and a non-fiduciary party in interest.[25] A "block trade" is any trade of at least 10,000 shares or with a market value of at least $200,000 that will be allocated across two or more unrelated client accounts of the investment manager directing the trade.[26] This exemption applies only to block trades in which:

- At the time of the transaction, the interest of the plan (and interests of other plans maintained by the same plan sponsor) does not exceed 10% of the aggregate size of the block trade; and
- At the time of the transaction, the terms of the transaction (including price and compensation) are at least as favorable as those of an arm's length transaction with an unrelated party.[27]

Foreign Exchange Transactions

The Act adds an exemption for certain foreign exchange transactions between a bank or broker-dealer (or an affiliate of either) that is a trustee, custodian, fiduciary or other party in interest to a plan where:

- The transaction is in connection with the purchase, holding, or sale of securities or other investment assets;
- At the time of the foreign exchange transaction, the terms of the transaction are at least as favorable as those of an arm's length transaction with an unrelated party;
- The exchange rate does not deviate more or less than 3% from the interbank bid and ask rates for transactions of comparable size and maturity at the time of the transaction, as displayed by an independent reporting service; and
- The bank or broker-dealer (and any affiliate of either) has no investment discretion regarding the transaction and provides no investment advice with respect to the transaction.[28]

Investment Advice to Plan Participants

The Act contains detailed provisions that generally permit certain transactions between a self-directed plan (such as a 401(k) plan) and a plan fiduciary (or an affiliate) in connection with the fiduciary's provision of investment advice to the self-directed plan's participants.[29]

Corrected Prohibited Transactions

Pending Changes

The Act provides that a party in interest can avoid engaging in an otherwise prohibited transaction (and avoid the associated excise taxes or civil penalties) in connection with the acquisition, holding, or disposition of any security or commodity, by reversing the transaction and restoring to the plan or account any profits made through the use of plan assets within a correction period.[30] The correction period is 14 days from the date the party in interest discovers (or reasonably should have discovered) that the transaction was prohibited.[31] The provision does not apply to any transaction involving the acquisition or sale of employer securities or employer real property or if at the time of the transaction the party in interest knew (or reasonably should have known) that the transaction would constitute a prohibited transaction.[32] These changes apply to any transaction which the

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23 *Id.*

24 *Id.*

25 Pension Protection Act of 2006, Section 611(a).

26 *Id.*

27 *Id.*

28 Pension Protection Act of 2006, Section 611(e).

29 Pension Protection Act of 2006, Section 601.

30 Pension Protection Act of 2006, Section 612.

31 *Id.*

32 *Id.*

party in interest discovers or reasonably should have discovered after the Act's enactment.[33]

Other Provisions

Bonding

Background

Section 412 of ERISA[34] provides that every fiduciary and every other person who handles plan funds or other plan property must be bonded. The amount of the bond must be fixed at the beginning of each plan year and must be at least 10% of the amount of the funds handled, with a minimum of $1,000 and a maximum of $500,000 per plan.[35]

Pending Changes

The Act exempts registered broker-dealers from the bonding requirements, so long as the broker-dealer is subject to the fidelity bond requirement of a self-regulatory organization under the Securities Exchange Act of 1934.[36] This change becomes effective in the first plan year following the Act's enactment.[37] The Act also raises the maximum bond required for plans holding employer securities from $500,000 to $1,000,000.[38] This change becomes effective in plan years beginning after December 31, 2007.[39]

Blackout Periods

Background

Section 404(c) of ERISA[40] permits a plan sponsor to transfer the responsibility and liability for selecting among the investment options in a self-directed plan (such as a 401(k) plan) to the plan's participants if certain conditions are met. Section 101(i)(7) of ERISA[41] contains certain advance notice requirements with respect to "blackout periods," generally defined as periods during which the ability of participants and beneficiaries to control their accounts is suspended.

Pending Changes

The Act extends the protection of Section 404(c) to blackout periods in cases where the plan sponsor or fiduciary has complied with ERISA's advance notice requirements.[42] The Act also extends Section 404(c) protection to changes in investment options implemented by the plan sponsor or fiduciary, provided certain requirements are satisfied.[43]

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Jacob I. Friedman is the Chair of Proskauer Rose's Tax Department. In recent years, his major areas of practice have been the structuring of alternative investments for pension trusts and other exempt organizations, and the rendering of fiduciary advice to ERISA trustees. Jay is an honors graduate of New York Law School and holds an LL.M. degree in taxation from New York University. Among his many professional affiliations, Jay is a Fellow of the American College of Investment Counsel.

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Ira G. Bogner is a partner in Proskauer Rose's Employee Benefits and Executive Compensation Group. Ira frequently is called on to structure and analyze alternative investments for pension trusts and other exempt organizations. Ira has substantial experience in applying ERISA's "plan assets" regulation, and routinely advises on the operation of venture capital and real estate operating companies. Ira received a B.A., cum laude from Brandeis University and a juris doctor degree from Fordham University.

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Jeffrey Ross is an associate in Proskauer Rose's Employee Benefits and Executive Compensation Law Practice Group. Jeffrey assists alternative investment funds in navigating ERISA's fiduciary and prohibited transaction rules and its regulation regarding "plan assets." He also represents pension plans as investors in alternative investment funds. Jeffrey received his B.A., cum laude from Yale University and his juris doctor degree from New York University.

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33 *Id.*

34 29 U.S.C. § 1112.

35 *Id.*

36 Pension Protection Act of 2006, Section 611(b).

37 Pension Protection Act of 2006, Section 611(h)(2).

38 Pension Protection Act of 2006, Section 622.

39 *Id.*

40 29 U.S.C. § 1104(c).

41 29 U.S.C. § 1021(i)(7).

42 Pension Protection Act of 2006, Section 621.

43 *Id.*