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Proskauer Hedge Start: Accepting Investments from Benefit Plan Investors Subject to ERISA

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Special rules may apply to hedge funds that accept investments by "benefit plan investors" (**Benefit Plan Investors**) subject to the Employee Retirement Income Security Act of 1974, as amended (**ERISA**), or Section 4975 of the Internal Revenue Code of 1986, as amended (the **Code**).

- "Benefit Plan Investors" include employee benefit plans subject to Title I of ERISA (such as traditional U.S. private sector pension plans and 401(k) plans), individual retirement accounts, Keogh plans and other plans or accounts subject to Section 4975 of the Code, as well as entities considered to be holding the "plan assets" of such plans or accounts.

When Is a Fund Considered to Hold "Plan Assets"?

ERISA and the "plan assets" regulation issued thereunder generally treat the assets of a hedge fund as "plan assets" subject to the fiduciary responsibility and prohibited transaction provisions of ERISA and Section 4975 of the Code if, immediately after the most recent acquisition, disposition, transfer or redemption of an interest in the hedge fund, Benefit Plans Investors own 25% or more of the value of the interests of any class of equity in the hedge fund.

- Any interests held by the manager of the hedge fund and its affiliates generally must be excluded from both the numerator and the denominator for purposes of calculating this 25% limit.

Key Takeaway: Compliance with the fiduciary responsibility and prohibited transaction provisions of ERISA and Section 4975 of the Code can be quite onerous for a hedge fund manager inexperienced in such matters. As a result, most hedge fund managers seek to keep the level of investments by Benefit Plan Investors in their funds below the ERISA 25% threshold at all times so as to avoid such obligations.

What Are the Consequences of Holding "Plan Assets"?

If a hedge fund's assets are considered "plan assets" for purposes of ERISA and Section 4975 of the Code (because the fund is over the 25% limit), then a number of additional requirements will apply to the operations and investments of the fund.

- Benefit Plan Investors generally will only be willing to invest in such a "plan asset" fund if the manager of the fund agrees to be appointed and act as each Benefit Plan Investor's "investment manager" under ERISA.
    - In order to qualify as an "investment manager", the manager must be either registered with the SEC as an investment adviser under the Investment Advisers Act of 1940, as amended, or be a U.S. bank or an insurance company, and the manager must acknowledge its fiduciary status under ERISA in writing.

- As an investment manager and fiduciary of the Benefit Plan Investors invested in the hedge fund, the manager will be subject to the general fiduciary duties imposed by ERISA, which include:
    - a duty of prudence (also referred to as the prudent expert standard of care), requiring the fiduciary to act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
    - a duty of loyalty, requiring the fiduciary to act solely in the interest of the Benefit Plan Investors;
    - a duty to diversify investments so as to minimize the risk of large losses;
    - a duty to act in accordance with the documents and instruments governing the Benefit Plan Investors; and
    - a duty to avoid engaging in non-exempt "prohibited transactions".

A few additional considerations for managers contemplating managing a "plan asset" hedge fund:

- generally speaking, the manager cannot be indemnified out of fund assets for a breach of fiduciary duty;
- the manager will need to confirm that all fund transactions either will not result in a "prohibited transaction" or the conditions of an available exemption will apply;
    - as a practical matter, the fund manager will need to qualify (and Benefit Plan Investors typically demand that a manager qualify) as a "qualified professional asset manager" (**QPAM**) in order to be able to rely on a broad

prohibited transaction exemption (commonly referred to as the "QPAM Exemption") to avoid engaging in certain types of prohibited transactions when managing a "plan asset" fund;

- the manager and its affiliates generally cannot engage in transactions with the fund (e.g., the manager cannot lend money to the fund or borrow money from the fund, buy assets from the fund or sell assets to the fund, or cause the fund to engage in transactions with other clients of the manager — so, generally no principal transactions or cross-trades);
- some manager compensation structures may not comply with the requirements of ERISA and may need to be revised so as to not result in impermissible conflicts of interest and prohibited transaction violations;
- the manager must comply with ERISA's fidelity bonding requirements;
- the indicia of ownership of the assets of the fund must generally be held within the United States, subject to certain limited exceptions for foreign securities and currencies; and
- additional ERISA reporting and disclosure requirements may apply.

Key Takeaway: Extreme care must be taken to avoid a breach of fiduciary duties or engaging in a non-exempt "prohibited transaction" under ERISA or Section 4975 of the Code, since either can result in significant liability to a hedge fund manager (including personal liability for losses, potential disgorgement of profits and excise tax penalties).

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