Ability Of Hedge Funds And Private Equity Funds To Attract Pension Investors Made Easier By The Pension Protection Act Of 2006

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The Pension Protection Act of 2006 (the "Pension Act"), signed into law by President Bush on August 17, 2006, includes important changes for hedge funds and private equity funds. The changes, which became effective immediately upon enactment, modify long-standing regulations of the U.S. Department of Labor under the Employee Retirement Income Security Act of 1974, as amended ("ERISA") that define the meaning of "plan assets" (the "Plan Asset Regulation"). The changes will allow hedge funds and private equity funds to increase subscriptions from pension plans, IRAs and other types of benefit plan investors without making their funds subject to various requirements of ERISA.

Generally, when a pension or other benefit plan invests its assets in another entity, the plan's assets include its investment, but not the underlying assets of the entity. However, under the Plan Asset Regulation, when a pension or other benefit plan invests in an entity that is neither publicly-traded nor registered under the Investment Company Act of 1940, the plan's assets are deemed to include both the plan's equity interest in the entity and an undivided interest in each of the underlying assets of the entity (this is often referred to as the "Look-through Rule").

Some of the consequences that can ensue when assets of a pooled investment fund are treated as "plan assets" include the following:

- the managers of the fund will be required to adhere to ERISA's fiduciary duty standards in the operation and management of the fund;
- the fund manager must be registered as an investment adviser under the Investment Advisers Act of 1940;
- care must be taken to avoid engaging in a "prohibited transaction" under ERISA; and
- the investments of the fund must be reported on annual governmental reports (Form 5500 series) that are open to the public.

To avoid these obligations and requirements, most hedge funds and private equity funds try to ensure that their assets will not be treated as "plan assets" in the first place. This can be accomplished by meeting one of two exceptions to the Look-through Rule. Under one exception, the Look-through Rule will be inapplicable if equity interests in the fund held by benefit plan investors are not "significant." A second exception applies if the fund qualifies as either a venture capital operating company ("VCOC") or a real estate operating company ("REOC"). Indeed, even funds that are structured to meet the VCOC or REOC exception often keep equity interests of benefit plan investors from becoming "significant" as a fail-safe against having assets of the fund treated as plan assets.

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Participation by benefit plan investors is considered "significant" as of any date if, immediately after the most recent acquisition of an equity interest in the fund, 25% or more of the value of any class of equity interests in the fund is held by "benefit plan investors." Prior to the enactment of the Pension Act, a "benefit plan investor" included not only plans subject to ERISA, such as pension, savings and welfare plans sponsored by U.S. employers ("ERISA-covered plans"), but also benefit plans that are not subject to ERISA, such as plans maintained by state and other governmental entities, churches or foreign employers ("non-ERISA plans") and individual retirement accounts ("IRAs").

As a result of the Pension Act, only ERISA-covered plans and IRAs (and entities the underlying assets of which are deemed to be plan assets by virtue of the Look-through Rule) are treated as "benefit plan investors" for purposes of the Plan Asset Regulation. Thus, equity interests of non-ERISA plans are no longer counted for purposes of determining whether participation by benefit plan investors is "significant." As a result of this change, hedge funds and private equity funds will be able to accept additional capital contributions from foreign, government and church plans, as well as from ERISA-covered plans and IRAs, without causing the fund's assets to be classified as "plan assets." This change will have beneficial effect for private equity funds, because, in many cases, it will permit them to raise more pension fund money while obviating the need to tailor their investments to satisfy the VCOC exemption. Because hedge funds can almost never satisfy the VCOC exemption (which requires active participation in portfolio companies, rather than passive investment), almost all hedge funds rely on the 25% limitation. Consequently, hedge funds will be especially benefited by the change to the rule.

The table to the right demonstrates the impact of the Pension Act on the Plan Asset Regulation.

Prior to the Pension Act, equity interests of benefit plan investors in the sample private equity fund shown would have been "significant" because they exceed 25% of all equity interests in the fund. However, following the Pension Act, equity interests of benefit plan investors in the sample fund decline to 20% because government, foreign and church plan investors no longer count as benefit plan investors. If investments by "Other Investors" remained unchanged, the sample fund could accept additional capital contributions of about $3.3 million from IRAs and ERISA-covered plans without causing investments by benefit plan investors to be treated as "significant."

As the example demonstrates, the Pension Act affords hedge funds and private equity funds the opportunity to increase capital contributions from foreign plans, governmental plans and church plans since interests of those investors will no longer count toward the 25% benefit plan investor limit. Likewise, the exclusion of those plans as benefit plan investors will "free up" some space for such funds to attract additional investments from ERISA-covered plans and IRAs.

The Pension Act also makes an important change to the Look-through Rule that will affect "funds of funds." Prior to the Pension Act, when one entity that is deemed to have "plan assets" invested in another entity, the entire investment in the second entity was treated as an investment by a benefit plan investor. Under the Look-through Rule as amended by the Pension Act, only a portion of the investment in the second entity is treated as "plan assets." The portion of the investment in the second entity that is treated as "plan assets" is equal to the amount representing the percentage of equity interests in the first entity that is owned by benefit plan investors.

The change to the Look-through Rule is important because only the investment in the second entity that is treated as an investment by a benefit plan investor will be counted as "plan assets" in determining whether investments by benefit plan investors in the second entity are "significant." The advantage of the revised Look-through Rule is readily seen from the following example:

Fund of Funds Example: Assume that 40% of Fund A's equity interests are held by benefit plan investors. If Fund A invests $10 million in Fund B, then under the revised Look-through Rule, Fund B will treat $4 million of Fund A's investment as an investment by a benefit plan investor in determining whether the equity interests of benefit plan investors in Fund B are "significant." Before the Pension Act, the full $10 million investment in Fund B would have been treated as an investment by a benefit plan investor.

The change in the law can also be meaningful for "master/feeder funds," as the following example illustrates:

Master/Feeder Example: Assume that Master Fund X receives investments from only Feeder Fund Y and Feeder Fund Z; that 40% of the equity interests in Feeder Fund Y are owned by benefit plan investors and that less than 25% of the equity interests in Feeder Fund Z are owned by benefit plan investors. If Master Fund X receives investments from Feeder Fund Y and Feeder Fund Z in the amount of $10 million each, none of Master Fund X's assets are treated as plan assets because the equity interests of benefit plan investors in Master Fund X represent only 20% of the equity interests in Master Fund X (that is, $4 million of Feeder Fund Y's investment is treated as made by benefit plan investors, representing 20% of the aggregate $20 million equity interests in Master Fund X.) Before the Pension Act, benefit plan investors would have been treated as owning 50% of the equity interests in Master Fund X and the assets of Master Fund X would therefore have been treated as plan assets.

It is not clear what motivated Congress to liberalize the Plan Asset Regulation. At a time when there are calls from various quarters to require hedge funds and private equity funds to provide greater disclosure of their investments and operations, to limit investments by pension plans in such funds, and to reverse the "retailization" of hedge funds represented in part by widespread investments by small individual investors through their pension funds, the changes to the Plan Asset Regulation seem to do just the opposite. By making it easier for hedge funds and private equity funds to avoid becoming subject to ERISA, it is less likely that the investments and operations of such funds will be subject to disclosure. In addition, by effectively raising the limit on the amount of capital investments that may be obtained from ERISA investors, the Pension Act makes it more (not less) likely that investments by ERISA investors in such funds will increase rather than decrease.

Source of Capital	Capital Investments in Sample Private Equity Fund
U.S. (Non-governmental) Employer-sponsored Pension Plans (i.e., ERISA-covered Plans) and IRA Investors	$10 million
Government, Foreign and Church Plan Investors (i.e., non-ERISA Plans)	$5 million
Other Investors	$35 million
Total Capital Invested:	$50 million
Total Capital Contributions of Benefit Plan Investors under the Plan Asset Regulation as in effect *prior to* the Pension Act	$15 million, representing 30% of Total Capital Invested ("Significant" under the Plan Asset Regulation)
Total Capital Contributions of Benefit Plan Investors under the Plan Asset Regulation *after* the Pension Act	$10 million, representing 20% of Total Capital Invested (*Not* "Significant" under the Plan Asset Regulation)

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