Bloomberg BNA

Pension & Benefits Daily ™

Time for a Second Look: Bringing the DOL's Plan Asset Regulations Into the 21st Century

BY JOHN J. CANNON III AND KENNETH J. LAVERRIERE

With considerable fanfare, the Obama administration announced in February that the Department of Labor would soon be issuing new regulations intended to clarify the relationship between financial advisers and their retirement plan and IRA clients. It is widely anticipated that the DOL will accomplish this by modifying its regulatory definition of ''fiduciary'' for purposes of ERISA.[1] As part of this update of its ERISA regulations, the DOL also should consider taking a second look at its so-called ''plan asset'' rules, which regulate the investment by retirement plans in private funds. A second look is warranted, because the plan asset rules are out of date and fail to provide intelligible guidance to fund managers or meaningful protection to plan investors.

[1] The Employee Retirement Income Security Act of 1974, as amended.

John J. Cannon III (jcannon@shearman.com) and Kenneth J. Laverriere (klaverriere@shearman.com) are partners in Shearman & Sterling LLP's Executive Compensation and Employee Benefits Group in New York and regularly speak and write on topics of compensation, benefits and governance.

Background on the Plan Asset Rules

The current plan asset rules were finalized in the mid-1980s and have not been updated or clarified much since, except for portions that were repealed by Congress as part of the Pension Protection Act of 2006. When the DOL promulgated the original plan asset rules, it was apparently concerned that asset managers would use investment funds to circumvent ERISA regulation. In its proposing release, the DOL stated that it would be ''inconsistent with the broad functional definition of 'fiduciary' in ERISA if persons who provide services that would cause them to be fiduciaries . . . are able to circumvent fiduciary responsibility rules of [ERISA] by the interposition of a separate legal entity between themselves and the plans.'' To address this concern, the DOL incorporated a ''look-through'' provision as the complex core of its plan asset rules.

Under the look-through rule, when an ERISA plan invests in a private fund or other entity, the plan is treated as owning not only an interest in the entity but also an undivided interest in each of the assets held by the entity, unless an exception applies. If the look-through rule applies to a fund, its assets become plan assets, and the persons who manage those assets become fiduciaries for all purposes of ERISA.

In essence, the DOL's look-through rule determines when the assets of a private fund or other collective investment vehicle are treated as plan assets regulated by ERISA. This is a big deal for both plans and fund managers. If the assets of the fund are plan assets, then the manager of the fund is an ERISA fiduciary to the plans that invest in the fund and must operate the fund in compliance with ERISA's fiduciary standards and prohibited transaction rules (which proscribe, among other things, the payment of most fees to an affiliate of the ERISA fiduciary).

Of equal importance, if the assets of a fund are considered plan assets, the plan is not only making an investment decision when it invests in the fund, but also is appointing a plan fiduciary for purposes of managing the plan's assets. If, on the other hand, the assets of a fund are not deemed to be plan assets, the manager of the fund generally does not have a fiduciary relation-

ship with its plan investors, and the only plan asset held by the plan investors will be the interest in the fund.

Given ERISA's complexity and the overly broad reach of its prohibited transaction rules, most private equity, hedge, real estate and infrastructure funds would have to restructure significantly if their assets were deemed to be plan assets and their fund operations were regulated by ERISA. Fund operations often require commercial transactions or affiliate relationships that do not comport with ERISA's prohibited transaction rules. The fee, indemnity, distribution and sidecar provisions in fund documents generally do not work for plan asset funds.

In addition, if a fund is a plan asset fund, third parties transacting with the fund would need to confirm that the fund manager or the applicable transaction qualifies under one or more ERISA exemptions that many fund managers typically do not comply with.

Most importantly, the strictures of ERISA's exclusive benefit rule would potentially limit the commercial flexibility necessary to operate a fund successfully for investors. A straightforward example is the appointment by a fund of an affiliate as a director of a portfolio company. If the assets of the fund were plan assets, the individual director would have an inherent conflict between the director's ERISA fiduciary duties to plan investors and the director's duties to the portfolio company. As a result, most private funds are forced to comply with one of the few exceptions to the look-through rule, and most large plan investors prefer, and in fact often require, funds to be operated in a manner that complies with an exception to the look-through rule.

Concerns With Current Exceptions to Look-Through Rule

There are only a limited number of exceptions to the look-though rule. ERISA includes an express statutory exception for registered investment companies and gives the DOL regulatory authority to craft other exceptions. The DOL's plan asset rules provide exceptions for certain investments in publicly traded securities and for investments in operating companies (i.e., generally, businesses that manufacture goods or provide services). The DOL regulations also provide an exception for private funds where the level of investment by benefit plan investors (not limited to ERISA plans) is not deemed to be significant (the so-called ''25 percent test'').

The plan asset rules also create exceptions for private funds that qualify either as venture capital operating companies (VCOCs) or real estate operating companies (REOCs), each of which requires awkward, artificial structuring that often creates tension with commercial objectives. Hedge funds typically rely on the 25 percent test; private equity, infrastructure and real estate funds rely on one of the artificial operating company exceptions.

Unfortunately, either by benign neglect or grand design, the DOL has provided little advice over the last four decades to clarify how its plan asset rules operate in practice.

To illustrate, there is little DOL guidance on how a class of equity securities is defined for purposes of the 25 percent test; no useful elaboration of the definition of ''management rights'' for purposes of the VCOC exception; no meaningful guidance on the use of subsidiaries and disregarded entities in structuring VCOC investments; no helpful guidance on when property is ''managed or developed'' for purposes of the REOC exception; and no transition rules for REOCs that are winding down their operations. And the list goes on.

Moreover, the private fund exceptions to the look-through rule force artificial structures on fund operations (with attendant ongoing compliance requirements and additional costs) and, in the case of the 25 percent test, limit access by benefit plan investors by unnecessarily constraining the amount they can invest in a fund.

The limited utility of the 25 percent test was illustrated after the 2008 recession, when declining asset values and fund redemptions forced some hedge funds to prematurely redeem ERISA investors in order to continue to comply with the test. This was an unfortunate result, because an original purpose of the plan asset rules was to allow pension funds to invest in alternative investment strategies through private funds, not to restrict fund operations or artificially limit access to these funds by ERISA investors.

Moreover, the artificial strictures imposed by the VCOC and REOC exceptions neither inform nor benefit ERISA fund investors. For example, the VCOC rules require a fund to obtain so-called ''management rights'' with respect to the portfolio companies in which the fund invests. However, the structuring of management rights (particularly for certain non-U.S. investment opportunities) can alter (sometimes negatively) the investment structure for a portfolio investment without offering any concomitant benefit to fund investors. Given that the fund manager is charged with the proper selection and oversight of investments, then plan investors should be agnostic as to whether the fund manager exercises this key function in a manner that results in the acquisition and exercise by the fund of management rights or by some other means.

Need for a New Approach

The burdens associated with complying with the private fund exceptions outweigh any benefit to retirement plans and, in some cases, may actually prove detrimental to the fund. As a result, a new approach is warranted.

Much has changed in the investment market since the DOL promulgated its original plan asset rules. The entities that manage private funds are subject to more regulation, and most U.S. fund managers are now registered under the Advisers Act.[2]

Large pension funds rely on private equity, hedge funds and other alternative asset classes to enhance portfolio returns, manage risk and diversify assets.

Increasingly, pension funds engage in direct investing in these asset classes. They also are sufficiently sophisticated to distinguish circumstances where investments should be managed directly by fiduciaries and where investments are better managed through a fund where ERISA fiduciary oversight of fund-level investment activity is not warranted. Perhaps most importantly, pension funds invest globally, and the VCOC and

[2] The Investment Advisers Act of 1940, as amended.

  ISSN

REOC rules needlessly complicate the structuring of cross-border investments in ways that in certain cases can limit access to non-U.S. investments by plans.

Both plan investors and fund managers have come to expect that a private fund's operations will not be regulated by ERISA. Private funds are structured to comply with an exception to the look-through rule, and sophisticated plan investors typically select funds that can demonstrate that they will not be subject to ERISA in operation. It seems reasonable, therefore, to encourage the DOL to consider a more direct approach that recognizes the evolution in plan investing and aligns more closely with these expectations.

A Better Alternative

To accomplish this, the DOL should consider amending its plan asset regulations to give private fund sponsors the choice to categorize certain funds as non-plan asset funds, regardless of the level of involvement by benefit plan investors. Under this check-the-box approach, a fund could be designated as a non-plan asset fund only if it targeted large plan investors, if certain information about the fund is provided to these investors and if the plan provides certain assurances regarding the level of sophistication of the persons advising the plan with respect to the investment.

The rules applicable to the regulation of swaps and other derivative transactions with pension funds, promulgated under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, provide a useful framework for this approach. When swap dealers deal with ERISA special entities, they must have a reasonable basis for believing that the special entity has a qualified, independent fiduciary assessing the suitability of the derivatives for the plan. In addition, the swap dealer has to represent that it is not acting for the plan and must provide certain details about the trade to the fiduciary acting for the plan.

A similar approach could be followed for funds that elect not to be plan asset funds. Subscribing plans would have to represent in subscription documents that they are of a requisite asset size and are represented by a qualified independent fiduciary. The pension plan would be required to acknowledge that the manager of the fund is not acting for the plan with respect to the decision to invest in the fund or to invest the assets of the fund. In addition, the election could only be made by funds that satisfy the disclosure requirements typically included in well-drafted offering statements, such as information about the fund's investment objectives, contribution requirements, withdrawal restrictions and fees.

Lastly, the new approach would need to address the DOL's original concern that the use of private funds not be done in a manner that circumvents ERISA's fiduciary rules where fiduciary oversight is warranted. There are a number of ways to address this concern: One approach would be to require a prescribed number of unaffiliated investors at the fund's initial closing. Another alternative would be to allow the exemption only for private funds with certain investment strategies that are offered to ''qualified purchasers'' or ''qualified institutional buyers,'' as such terms are defined for purposes of U.S. securities laws.

The approach outlined above would supplement, not replace, the DOL's existing plan asset regulations. The change would align better with current market practices, provide better guidance to fund managers and, most importantly, focus the DOL's regulations on matters that better serve and protect plan investors.