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Hedge Fund
Compliance with ERISA 25% Limit

I. BACKGROUND

Hedge funds are, generally speaking, private investment funds that are not registered under the Investment Company Act of 1940, as amended (the "*1940 Act*"), and that offer and sell equity interests in their funds in private placement transactions.[1] Hedge funds have become an increasingly attractive investment alternative for pension plans because they often pursue strategies that do not correlate with the broader debt and equity markets and, therefore, can assist pension plan fiduciaries in complying with their statutory duty to diversify their plans' portfolios.

Investments in hedge funds by pension plans governed by the Employee Retirement Income Security Act of 1974, as amended ("*ERISA*"), or the "prohibited transaction" rules of Section 4975 of the Internal Revenue Code of 1986, as amended (the "*Code*"), raise special issues for the managers of those funds. Depending upon the structure and operation of a hedge fund, its assets may be considered "plan assets" for purposes of ERISA and Section 4975 of the Code. For the reasons discussed below, hedge fund managers, however, typically seek to structure their funds so that their assets are not characterized as "plan assets" for purposes of ERISA and the Code.

This memorandum outlines the requirements of, and legal and practical issues raised by, compliance with the so-called "25% Limit" - the approach that hedge fund managers commonly use so that their funds' assets are not considered "plan assets" for purposes of ERISA and Section 4975 of the Code.

II. AVOIDING THE ERISA REGIME

The Department of Labor's ("*DOL*") plan asset regulations (the "*Plan Asset Regulations*")[2] define what constitutes "plan assets." The Plan Asset Regulations provide as a general rule that, when an employee benefit plan governed by ERISA or Section 4975 of the Code (a "*Plan*") invests in an entity, the Plan's assets include the Plan's investment but do not, solely by reason of such investment in the entity, include any of the underlying assets of the entity. However, as in the case of a hedge fund, where the Plan's investment is an equity interest that is not a publicly offered security or a security issued by a company that is registered under the 1940 Act, the Plan's assets include both the equity interest and an undivided interest in each of the underlying assets of the hedge fund unless one of the exceptions in the Plan Asset Regulations is satisfied. The exception most commonly used by hedge funds provides that assets of a hedge fund in which a Plan has invested will not be considered "plan assets" if the equity participation in the fund by "benefit plan investors" is not "significant" (the "*25% Limit*").[3]

If a hedge fund does not comply with the 25% Limit, and the hedge fund does not meet one of the other exceptions under the Plan Asset Regulations, then the assets of the hedge fund will be deemed "plan assets" for purposes of ERISA and Section 4975 of the Code. The consequences of this would include:

- the hedge fund's manager would be a fiduciary of each Plan investor governed by ERISA, and the manager's activities would be subject to the general fiduciary requirements of Section 404 of ERISA;
- all of the hedge fund's activities would be subject to the prohibited transaction rules of Section 406 of ERISA and Section 4975 of the Code. Among other things, transactions with affiliates would be restricted, and performance fees charged by the hedge fund manager would need to be structured to ensure compliance with applicable DOL guidelines; and
- in many instances, failure to comply with the 25% Limit would result in a withdrawal or redemption of the capital committed by Plans, which may have a material adverse impact on a hedge fund's operations.

III. COMPLYING WITH THE 25% LIMIT

A. General

To comply with the 25% Limit, equity participation in a hedge fund by "benefit plan investors" must not be "significant." Equity participation will not be considered "significant" if benefit plan investors, in the aggregate, hold less than 25% of the value of *each* "class" of equity interests issued by the hedge fund, excluding interests held by certain persons, including managers or investment advisers to the hedge fund and their affiliates.

B. Benefit Plan Investors

The Plan Asset Regulations define a "benefit plan investor" broadly as:

- any employee benefit plan, whether or not subject to ERISA and whether or not covering U.S. employees (including governmental plans, church plans and non-U.S. plans);
- any plan described in Section 4975(e)(1) of the Code, including individual retirement accounts and Keogh plans; and
- any entity whose underlying assets include "plan assets" by reason of an employee benefit plan's investment in the entity (*e.g.*, insurance company separate accounts or collective investment vehicles, including other hedge funds, that do not comply with the 25% Limit).

Thus, the term "benefit plan investor" includes plans that are not themselves subject to ERISA.

C. "Class" of Equity Interests

The 25% Limit must be satisfied separately with respect to each "class" of "equity" issued by a hedge fund. For example, assume that a hedge fund has two classes of equity, with Class A representing 80% of the entity's total equity and Class B representing the remaining 20% of the entity's total equity. If benefit plan investors own less than 25% of the Class A interests and 25% or more of the Class B interests, then the assets of the entire hedge fund will be considered plan assets. This is true even though benefit plan investors own less than 25% of both the Class A interests and the total equity of the hedge fund.

A difficult issue faced by many hedge fund managers is determining what constitutes a separate "class" of equity for purposes of the 25% Limit. The DOL has not issued any guidance on this issue. However, the following general observations can be made:

- If application of the local law of the jurisdiction where a hedge fund is established would result in the creation of separate classes (*e.g.*, because of differences in voting or liquidity rights or advisory fees applicable to different investors), then separate classes should exist for purposes of determining compliance with the 25% Limit.
- If the governing documents of a hedge fund provide, in form, for separate classes of securities, those distinctions generally should be respected for purposes of determining what constitutes a separate "class" of equity interests.
- Where investors are restricted from participating in the allocation of "new issue" securities under the rules of the National Association of Securities Dealers, Inc. ("*NASD*"), they should normally be considered to hold a separate class of securities from investors who can participate in new issues.[4]
- Significant economic differences in the interests in a hedge fund might result in the creation of separate classes of securities, even if the governing documents of the hedge fund do not provide for "separate" classes. For example, if the hedge fund has differing fee structures or liquidity rights or obligations among investors, such distinctions might be significant enough under certain circumstances to create separate "classes" of equity for purposes of applying the 25% Limit.
- Side letters providing Plans or other investors with special rights might also result in the creation of separate classes, depending upon the particular circumstances, and thus caution should be exercised when entering into such arrangements.

D. Calculation of the 25% Limit

In applying the 25% Limit to a hedge fund, the value of any equity interest held by the following persons (other than a benefit plan investor) is disregarded:

- any person who has discretionary authority or control with respect to the assets of the hedge fund (*e.g.*, the general partner or managing member of a hedge fund);
- any person who provides investment advice for a fee (direct or indirect) with respect to such assets (*e.g.*, the investment manager of a hedge fund); or
- any "affiliate" of the above.

Under the Plan Asset Regulations, an "affiliate" of a person includes "any person, directly or indirectly, through one or more intermediaries, controlling, controlled by, or under common control with the person." The Plan Asset Regulations define "control" with respect to a person other than an individual as "the power to exercise a controlling influence over the management or policies of such person." The DOL has not issued any specific guidance on what constitutes “control” and the determination, in each case, will depend on the facts and circumstances.

The DOL is currently considering several interpretive issues raised by “master-feeder” and other tiered investment structures, but, to date, has not issued any guidance. Issues raised by these investment structures include:

- How should “master-feeder” structures be treated where multiple feeder funds are used? For example, when determining a master fund’s compliance with the 25% Limit, should all the benefit plan investors in the separate feeder funds be taken into account, even where one or more of the feeder funds standing alone comply with the 25% Limit? For example, should such an integration of the feeder funds be required where the feeder funds do not have an independent business purpose?
- If an entity fails to satisfy the 25% Limit solely as a result of investment by benefit plan investors that are not subject to ERISA or Section 4975 of the Code (*e.g.*, foreign plans), should the entity be treated as a benefit plan investor for purposes of investments it makes in other entities? While the drafting of the Plan Asset Regulations may support the conclusion that such an entity would not be a benefit plan investor, that analysis appears inconsistent with the DOL’s policy objective in taking into account non-ERISA plans in determining compliance with the 25% Limit.

E. Monitoring Compliance with the 25% Limit

A hedge fund intending to comply with the 25% Limit must have procedures in place to monitor the percentage interest held by benefit plan investors. Further, because of concerns that a prohibited transaction or other breach of fiduciary duty could occur, plan investors in hedge funds are increasingly seeking contractual rights permitting the monitoring of a hedge fund’s compliance efforts with the 25% Limit and withdrawal rights in the event that the 25% Limit is exceeded.

Typically, hedge fund managers monitor compliance by requiring a purchaser to represent whether it is a “benefit plan investor” and tracking benefit plan investor interests at the time of each subscription, redemption or transfer of an interest in the hedge fund. The subscription documents for a hedge fund should also require investors to notify the hedge fund manager if their status as a benefit plan investor changes. The documents governing the hedge fund typically include restrictions on the right to purchase, transfer or redeem equity interests (or a right to require a benefit plan investor to redeem its interest) that the hedge fund manager can impose if necessary to ensure continued compliance with the 25% Limit.

IV. CONCLUSION

The increased investment volume by Plans in hedge funds has put further pressure on hedge fund managers with respect to ensuring compliance with the 25% Limit, particularly in light of the intricacies and uncertainties highlighted above. As a result, hedge fund managers should ensure that they have adequate policies and procedures in place to reduce the risk of non-compliance with the 25% Limit.

ENDNOTES

1. *See* “Registration Under the Advisers Act of Certain Hedge Fund Advisers,” Securities and Exchange Commission Release No. IA-2266 (July 28, 2004) (proposing a rule requiring registration of hedge fund advisers under the Investment Advisers Act of 1940).
2. *See* 29 U.S.C. § 2510.3-101.
3. The other principal exception under the Plan Asset Regulations, which is generally not applicable to hedge funds, provides that the assets of an entity will not be considered “plan assets” if the entity is an “operating company,” including a “venture capital operating company” or a “real estate operating company.”
4. For more information on the NASD’s “new issue” rule, *see* “NASD Rule 2790 Revises Restrictions on the Purchase and Sale of Initial Equity Public Offerings,” currently available at <http:/www.shearman.com/documents/AM_10-11-03.pdf>.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired. For more information on the topics covered in this issue, please contact:

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