Congress Overhauls
ERISA Plan Asset and Prohibited Transaction Rules

The Senate and House have now both passed the Pension Protection Act of 2006 (the “Act”), which contains comprehensive pension reform legislation covering a wide range of subjects, including the funding of defined benefit pension plans, the provision of investment advice to participants in individual account plans and the application of the “plan asset” and prohibited transaction rules under the Employee Retirement Income Security Act of 1974, as amended (“ERISA”). We focus in this memorandum on the changes to the “plan asset” and prohibited transaction rules, which include a revised definition of “plan assets” for purposes of ERISA, various amendments to the prohibited transaction rules of ERISA and the Internal Revenue Code of 1986, as amended (the “Code”), and changes to the bonding requirements under ERISA. The President has indicated that he intends to sign the Act into law. When enacted, the Act will increase the capacity for collective investment funds to accept pension plan investments without becoming subject to the fiduciary and prohibited transaction rules of ERISA and the Code. In addition, service providers to plans will be able to engage in a greater number of transactions with plans in reliance on a number of statutory exemptions from the prohibited transaction rules that are included in the Act.

Current Law

The current regulations under ERISA provide that, notwithstanding investment in an entity by plans or other investors subject to Title I of ERISA or Section 4975 of the Code (“ERISA Investors”), the assets of the entity will not be subject to the fiduciary and prohibited transaction rules of ERISA or Section 4975 of the Code if at all times less than 25% of the value of each class of equity interests of the entity are held by “benefit plan investors.” The current definition of “benefit plan investors” includes not only ERISA Investors, but other plans such as non-U.S. plans, governmental plans and church plans, as well as entities that are deemed to hold “plan assets” by reason of a plan’s investment in the entity. In calculating the 25% limit on benefit plan investors, interests held by a person (other than a benefit plan investor) who has discretionary authority or control with respect to the assets of the entity, or who provides investment advice for a fee with respect to the assets of the entity, or any affiliate of such a person, must be disregarded. If the 25% limit is exceeded and the entity does not meet any other exception to the “plan

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asset” rules (e.g., its securities are not publicly offered and it is not a registered investment company, a “venture capital operating company” or a “real estate operating company”), 100% of the assets of the entity would be considered “plan assets” for purposes of ERISA.

Because of these rules, fund managers who have been unwilling to be subject to the increased regulatory burden of ERISA have often been required to turn away ERISA Investors and other benefit plan investors seeking to invest in their funds. Many view the restriction on ERISA Investors and other benefit plan investors to invest in these funds to be a significant disadvantage to these investors. In addition, fund managers have often faced uncertainty as to how this rule applies in different contexts. For example, it is unclear whether a fund of funds (“FOF”) in which only non-U.S. plans or governmental plans invest would be considered a “benefit plan investor” for purposes of its investments in underlying funds.

The Act

The Act makes welcome changes to the “plan asset” rules and adds new prohibited transaction exemptions. The Act:

- revises the definition of “benefit plan investors” so that only ERISA Investors and entities whose assets include “plan assets” of ERISA Investors are considered “benefit plan investors.” Thus, investments by non-U.S. plans, governmental plans and church plans will no longer count when determining whether participation by benefit plan investors exceeds the 25% limit. This change will not only increase the ability of funds to accept investments from ERISA Investors but will also resolve the uncertainty managers currently face regarding the treatment of entities in which only non-ERISA benefit plan investors invest; and

- provides that if the 25% limit is exceeded, an entity will only hold “plan assets” to the extent of the percentage of the entity owned by ERISA Investors. Thus, for example, if ERISA Investors hold 30% of a FOF, and that FOF makes a $10 million investment in an underlying fund, only $3 million of the investment by the FOF will count as ERISA Investor money when calculating the 25% test at the underlying fund level.

In addition to the changes above, the Act also exempts the following transactions between plans and parties in interest from the prohibited transaction rules of ERISA and Section 4975 of the Code:

- **Transactions with Service Providers.** The Act exempts transactions involving the sale, exchange or leasing of property, extension of credit or transfer of “plan assets” between a plan and a person that is a party in interest (other than a fiduciary who has or exercises discretionary authority or control with respect to the investment of the assets of the plan involved in the transaction or renders investment advice for a fee with respect to those assets
(or an affiliate)) if (i) the person is a party in interest solely by reason of providing services to the plan or by reason of its relationship to a service provider and (ii) the plan pays no more, and receives no less, than “adequate consideration.” Adequate consideration means (1) in the case of securities for which there is a generally recognized market, the price prevailing on a national securities exchange or, if not traded on a national exchange, a price no less favorable than the offering price for the security based on current bid and ask prices quoted by independent third parties and (2) for other assets, the fair market value of the asset as determined in good faith by a fiduciary in accordance with regulations prescribed by the Secretary of Labor (the “Secretary”).

- **Block Trades.** The Act exempts transactions involving the purchase or sale of securities or other property (as determined by the Secretary) between a plan and a party in interest (other than certain fiduciaries with respect to the plan) if (i) the transaction involves a block trade (i.e., any trade of at least 10,000 shares or with market value of at least $200,000 which will be allocated across two or more unrelated client accounts of a fiduciary), (ii) the interests of the plan (together with the interests of other plans maintained by the same plan sponsor) do not exceed 10% of the aggregate size of the block trade, (iii) the compensation associated with the purchase and sale is not greater than that associated with an arm’s length transaction with an unrelated party, and (iv) the terms of the transaction are at least as favorable to the plan as an arm’s length transaction.

- **Cross Trading.** The Act exempts transactions described in Sections 406(a)(1)(A) and 406(b)(2) of ERISA or Section 4975(c)(1)(A) of the Code involving the purchase or sale of a security between a plan and any other account managed by the same investment manager if (i) each plan participating in the transaction has assets of at least $100 million, (ii) the purchase or sale is for no consideration other than cash payment against delivery of securities for which market quotes are readily available, (iii) the transaction is effected at the independent current market price, (iv) no brokerage commission, fee or other remuneration (except for customary transfer fees if disclosed) is paid in connection with the transaction and the manager does not base its fee schedule or the provision of other services on the plan’s consent to cross trading, (v) the manager has policies and procedures in place that allocate cross trades in an objective manner among accounts participating in the cross trading program, (vi) a plan fiduciary (other than the investment manager engaging in the cross trade or its affiliate) authorizes the manager to engage in cross trades in the manager’s discretion after receiving a separate disclosure document that includes the manager’s policies on cross trading, and (vii) the manager provides a quarterly report to the fiduciary identifying all cross trades involving the plan for that quarter as well as an annual report (signed under penalty of perjury) describing the level of compliance with the manager’s policies on cross trades and
specific instances of non-compliance and notifying the fiduciary of its right to terminate the plan’s participation in the cross trading program at any time. No later than 180 days after enactment of the Act, the Secretary, in consultation with the Securities and Exchange Commission, will issue regulations regarding the content of the policies and procedures that are required to be adopted by the manager.

- **Foreign Exchange Transactions.** The Act exempts foreign exchange transactions between a bank or broker-dealer (or an affiliate of either) and a plan with respect to which the bank, broker-dealer or any affiliate is a trustee, custodian, fiduciary or other party in interest if (i) the transaction is in connection with the purchase, holding or sale of securities or other investment assets, (ii) the exchange rate used by the bank, broker-dealer or affiliate does not deviate more or less than 3 percent from the inter-bank bid and ask rates for comparable transactions displayed on an independent service, (iii) the bank, broker-dealer or affiliate does not have investment discretion, or provide investment advice, with respect to the transaction, and (iv) the terms of the transaction are not less favorable to the plan than the terms of a comparable arm’s length transaction between or involving unrelated parties.

- **Electronic Communication Networks.** The Act exempts transactions involving the purchase or sale of securities or other property (as determined by the Secretary) between a plan and a party in interest if (i) the transaction is executed through an electronic communication network, alternative trading system or similar execution system or trading venue subject to regulation and oversight by the applicable federal regulating entity (or such foreign regulatory entity as the Secretary may determine), (ii) either the system and the parties to the transaction do not take into account the identity of the parties to the transaction or the transaction is effected pursuant to rules designed to match purchases and sales at the best price available through the system, (iii) where the party in interest has an ownership interest in the system, the plan sponsor or other independent fiduciary authorizes the use of the system, (iv) a plan fiduciary is provided with at least 30 days’ prior notice of the initial transaction executed over the system with respect to the plan, and (v) the price and compensation associated with the purchase and sale are not greater than an arm’s length transaction with an unrelated party.

- **Corrected Transactions.** The Act exempts transactions described in Section 406(a) of ERISA or Sections 4975(c)(1)(A)-(D) of the Code in connection with the acquisition, holding or disposition of any security or commodity if (i) the transaction does not involve the acquisition or sale of employer securities or employer real property between a plan and a plan sponsor or its affiliates and (ii) the transaction is corrected within 14 days beginning on the date on which the party in interest discovers, or reasonably should have discovered, that the
transaction would constitute a prohibited transaction. The exemption is not available if at the time the transaction occurs, the party in interest knew (or reasonably should have known) that the transaction would constitute a prohibited transaction.

The Act also provides an exemption from the bonding requirements applicable to fiduciaries under Section 412 of ERISA for entities that are registered as brokers or dealers under Section 15(b) of the Securities Exchange Act of 1934 if the broker or dealer is subject to the fidelity bond requirements of a self-regulatory organization.

**Effective Date**

The changes described in this memorandum will generally apply to transactions occurring after the date of enactment of the Act, with the following exceptions:

- the exemption from the ERISA bonding requirement will apply to plan years beginning after the date of enactment of the Act; and

- the exemption relating to corrected transactions will apply to any transaction that the party in interest discovers, or reasonably should have discovered, constitutes a prohibited transaction after the date of enactment of the Act.

**Action Items**

- **Definition of “Plan Assets”**

With respect to the changes to the definition of “plan assets,” managers of collective investment funds should inventory their organizational and offering documents, subscription documents, management agreements and agreements with investors to confirm whether the documents will need to be supplemented or revised to reflect these changes, and whether any changes to existing fund structures should be made to take advantage of the law when enacted. In some cases, the additional ERISA capacity that will be generated by the Act may result in entities not being subject to the fiduciary and prohibited transaction rules of ERISA and the Code with respect to transactions occurring after the date of enactment. In other cases, such as private equity, venture capital and other buyout funds, entities may have additional flexibility to accept ERISA Investors without having to qualify as a “venture capital operating company” or a “real estate operating company.” In all cases, consideration must be paid to any existing contractual commitments to operate an entity as if subject to the prior rules, as well as any required disclosures or consents that must be made to, or obtained from, existing investors before undertaking any change in the operations of the entity. Managers of FOFs will also need to consider what impact the change to a proportionality approach will have on their procedures for monitoring investments by ERISA Investors and reporting a FOF’s “plan asset” status to underlying fund managers.
• Prohibited Transaction Exemptions

With respect to the changes to the prohibited transaction rules, fiduciaries and other service providers to plans should consider the impact of the exemptions on their relationships with plans and existing service agreements, as transactions that were previously prohibited may now be subject to a statutory exemption. The conditions of each applicable exemption should be carefully reviewed to determine what changes will need to be made in order to satisfy the requirements of the exemption (including changes to existing trading policies and service agreements). In many cases, managers may need to prepare new disclosure documents for plans, obtain additional representations and authorizations from plans, and put in place or confirm the effectiveness of various policies or safeguards before relying on the relevant exemption. Also, a few of the exemptions will require additional guidance from the Secretary (such as the cross trading exemption) before managers can rely on the exemption.

• Bonding

Many fiduciaries will no longer be required to obtain a bond under Section 412 of ERISA beginning in the next plan year in light of the new exemption from the bonding requirement provided under the Act.

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If you have any questions about the foregoing, please call your regular Fried Frank contact or any of the attorneys listed below.

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