

## ERISA Plan Asset Limitations

The Department of Labor's ("DOL") plan asset regulations (the "Plan Asset Regulations") 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, 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 fund unless one of the exceptions in the Plan Asset Regulations is satisfied.

**The exception most commonly used by private funds provides that assets of such 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.** 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 fund, excluding interests held by certain persons, including managers or investment advisers to a hedge fund and their affiliates (the "25% Limit").

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 ("IRAs") 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.

The 25% Limit must be satisfied separately with respect to each class of equity issued by a fund. For example, assume that a 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 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 fund.

Why does it matter? If a fund does not comply with the 25% Limit, and the fund does not meet one of the other exceptions under the Plan Asset Regulations, then the assets of the fund will be deemed plan assets for purposes of ERISA and Section 4975 of the Code.

The consequences of this would include:

- The 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; and
- **All of the 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 some types of performance fees charged by the fund manager would need to be structured to ensure compliance with applicable DOL guidelines.