

# Woodfield Wire

AN E-NEWSLETTER FOR HEDGE FUND MANAGERS  
AND OTHER INDUSTRY PROFESSIONALS

Woodfield's monthly e-newsletter publishes articles about hedge fund-related topics and best practices. To subscribe, please send an email to [newsletter@woodfieldllc.com](mailto:newsletter@woodfieldllc.com). We welcome your comments and ideas.

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## Hedge Funds and ERISA

Several days ago one of our customers called with a question. He's a hedge fund manager and has identified a potential opportunity to take in some new capital that would come from ERISA plans.

Now, ERISA is the Employee Retirement Income Security Act of 1974, a complicated piece of legislation administered by the U.S. Department of Labor (DOL) that deals with employee benefit plans. Most hedge funds are careful to include no more than 25% from sources having to do with ERISA so that they won't be subject to the many requirements and prohibitions that ERISA imposes on retirement plans.

In this case, my client realized that taking in additional ERISA money would cause him to go over the 25% limit, and he wanted to know:

### What happens if your fund exceeds the 25% limit?

First of all, this is a complicated issue, so if you have concerns in this area, we encourage you to contact an attorney who is well versed in ERISA law. We spoke with Fred R. Green, an attorney at [Herrick, Feinstein LLP](http://Herrick, Feinstein LLP)'s New York office who has extensive experience on the subject, and he offered the following general information.

### What Funds are Plan Assets?

The ERISA restrictions hang on the definition of certain funds as benefit plan assets, so it's important to understand how those are determined. Here's an excerpt from the helpful and hefty handbook, [\*Hedge Funds and Other Private Funds: Regulation and Compliance\*](#), by Thomas P. Lemke et al.:

"A hedge fund generally is able to avoid ERISA's application if it limits the level of investment by 'benefit plan investors' to less than 25% of any class of the fund's equity. In these circumstances, the assets held by the hedge fund are not considered 'plan assets' and, thus, are not subject to ERISA. Where a master-feeder fund structure is used, the 25% threshold would be calculated for each fund in the structure . . .

"If a feeder fund is not deemed to be a 'plan asset' fund, then none of its investment in the master fund is considered to come from 'benefit plan' investors. If a feeder fund is deemed to be a plan asset fund, then only the portion of its assets that came from benefit plan investors are considered in calculating the master fund's investments from benefit plan investors."

The handbook goes on to list four considerations that make these plan requirements tricky: **Making sure to count all benefit plan investors** (not only corporate pension plans but Taft-Hartley plans,

certain church-sponsored plans, IRAs, and the portion of other funds, such as fund of funds, that come from benefit plan investors to the extent that such other funds themselves have 25% or more benefit plan investors in their fund); the fact that **investments by the fund manager and affiliates should be disregarded** when calculating the baseline amount subject to the 25% threshold; **testing on a class basis**, not on the fund's equity as a whole; and the need to **continuously monitor the percentage** (not just when an investor purchases shares in a fund but also when investors redeem shares, since that can upset the ERISA percentage of the remainder).

By the way, Individual Retirement Accounts (IRAs) are considered benefit plan money, but they are not covered under ERISA as long as there are no other funds in the class that are considered ERISA funds. However, as soon as you take in some other funds that are subject to ERISA, suddenly the IRA funds also count toward the 25% limit. (Be aware that the Internal Revenue Service has its own set of rules regulating IRAs, including the prohibition of certain transactions.)

### ERISA Restrictions That Would Affect Many Hedge Funds

If the 25% threshold is exceeded, then the assets of the hedge fund will be considered benefit plan assets and the fund manager will be required to comply with ERISA's fiduciary rules and restrictions. In such a case, some of the ERISA issues that may be applicable include the following:

- **Performance fees.** Most hedge fund managers receive some sort of performance fee from investors. If you go over the 25% ERISA threshold, the manner in which the performance fee is calculated and paid could violate ERISA. This is particularly true if your fund has side pockets or illiquid securities.
- **Dealing with "parties in interest."** ERISA defines certain persons or entities with special relationships to a specific benefit plan (such as a sponsor of a benefit plan, a 10% or more shareholder of the sponsor of a benefit plan, a fiduciary or person providing services to a benefit plan, etc.) as a "party in interest." Unless an exemption exists, a prohibited transaction under ERISA will occur if the hedge fund enters into a transaction with a "party in interest" to any of its benefit plan investors. Among other things, the fund manager would be liable for any losses suffered and other penalties in connection with causing the fund to enter into a prohibited transaction for which no exemption exists.
- **Custody of Foreign Assets.** If your fund were to become subject to ERISA, your ability to hold assets outside the United States would be limited, depending on the fund's structure and prime brokerage/custody arrangements.
- **Expenses.** Hedge funds and investment funds typically write off administrative and operational expenses, but funds governed by ERISA are limited as to expenses that can be borne by the fund.
- **Reporting.** If your fund becomes subject to ERISA, you may be required to file periodic reports with the Department of Labor.
- **Potential plan sponsor liability.** If a hedge fund's manager isn't registered under the Advisers Act but the fund is determined to hold retirement plan assets, the plan's trustees could become liable for the fund manager's investment decisions.

### ERISA Restrictions That Would Only Affect Some Hedge Funds

- **Soft dollars and brokerage commission.** With proper disclosure, a hedge fund may obtain "soft dollar" services from a broker or prime broker--things like office space, clerical support or marketing. Under ERISA, the scope of services that may be received through "soft dollars" is limited.
- **Investment in employer securities.** Under ERISA, the fund manager would need to monitor the fund's ownership levels in companies whose pension plans have invested in the fund.

## Staying Safe

If you go over the 25% threshold, it is not as if the government would automatically rush in and arrest everyone. But you would be operating under another regulatory framework, subject to the ERISA fiduciary requirements, including the requirements listed above, and vulnerable to additional liabilities.

**So it's important to keep track of the percentage of your investments that are ERISA funds.**

Again, this is a complicated matter, so if it pertains to you, we encourage you to consult with an attorney who thoroughly understands ERISA.

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