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How Hedge Funds Can Avoid Becoming Subject to ERISA

The U.S. Employee Retirement Income Security Act of 1974 (ERISA) is a federal law that governs the management and investment of U.S. private sector employee benefit plans. It aims to protect plan participants from conflicts of interest and imprudent decision-making. ERISA imposes stringent standard of care requirements on "fiduciaries" and prohibits a wide range of transactions absent adherence to an exemption. A breach of a fiduciary duty under ERISA or a non-exempt prohibited transaction under ERISA or Section 4975 of the U.S. Internal Revenue Code of 1986 (Code) can result in severe penalties, including civil liability and excise taxes.

Numerous hedge fund sponsors/managers try to avoid becoming subject to ERISA due its technical requirements and potential liability. The most prominent way in which sponsors/managers avoid ERISA is by structuring its fund to fall within a safe harbor, the significant participation test. This client alert focuses on that safe harbor. (Sponsors and managers of other alternative funds, such as private equity, may rely on other safe harbors). We will address in a future client alert the ramifications for a fund sponsor/manager if its hedge fund becomes subject to ERISA.

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A hedge fund manager is a fiduciary under ERISA if it has discretionary management over "plan assets." An ERISA plan's investment in a hedge fund would generally convert the fund into a "plan assets" ERISA investment vehicle. A hedge fund that holds "plan assets" would subject the investment manager to ERISA, including strict fiduciary duties and prohibited transaction restrictions.

However, Department of Labor (DOL) regulations provide a safe harbor from "plan assets" status on which many hedge funds rely. Simply, a hedge fund avoids becoming subject to ERISA if "benefit plan investors" hold less than 25% of each equity class (excluding any interests held by the general partner or investment manager). This test is conducted on a class-by-class basis. Section 3(42) of ERISA and applicable DOL regulations define "benefit plan investors" (BPIs) as plans subject to the fiduciary responsibility provisions of ERISA, plans subject to Section 4975 of the Code (e.g., IRAs), and fund investors that are themselves plan asset vehicles. Subscriptions from governmental plans and non-U.S. plans are not counted toward the 25% limit. Subscription booklets will often include an ERISA questionnaire to ascertain whether a potential investor is a BPI for purposes of determining whether the fund falls within the safe harbor.

Fund sponsors/managers need to be vigilant and recognize that the test is recalculated at the time of each new subscription, transfer and redemption into and out of the hedge fund. If the 25% threshold is met or exceeded, the fund immediately becomes an ERISA "plan assets" vehicle and the investment manager must comply with ERISA. Hedge fund sponsors/managers that wish to avoid this result will typically have certain rights to ensure the fund stays within the safe harbor. The sponsor/manager will probably have the right to require BPIs to redeem out of the fund if the 25% threshold may be breached. The sponsor/manager should also have the right to approve any prospective transfer of interests. Most BPIs do not object to these types of provisions. Some ERISA plan investors may negotiate certain rights in a side letter, such as a requirement that the mandatory redemption provisions be implemented against all BPIs in an equitable manner. It would be important to evaluate whether granting too many, or certain, rights in a side letter inadvertently creates a new "class," thereby undermining the strategy of avoiding "plan assets" status.

The significant participation test is tested on an entity-by-entity basis. This means that, in a master-feeder structure, each feeder fund and the master fund are all tested separately. Some fund sponsors attempt to "hardwire" their feeder funds as a way to increase ERISA capacity while still falling within the safe harbor. Under this structure, the offshore feeder fund would hold "plan assets" because 25% or more of its share class will be held by BPIs, whereas both the domestic feeder fund and master fund would avoid holding "plan assets" by satisfying the significant participation test. Both feeders would have to invest all of their investible assets in the master fund. Some take the position that, even though the offshore feeder holds "plan assets," the investment manager is not an ERISA fiduciary because the manager effectively has no discretion or ability to trade out of the feeder. This allows hedge fund sponsors/managers to increase ERISA capacity while avoiding ERISA compliance. Hardwiring may not be feasible for all funds, so this should be considered early in the structuring process.

The safe harbor/significant participation test does not address the idiosyncratic issues associated with governmental plans. These plans are not subject to ERISA and they have their own set of rules and investment restrictions. Governmental plans may have their own "look through" to the hedge fund's operations, regardless of whether the fund holds "plan assets" under ERISA. It is important for hedge fund sponsors/managers to independently confirm whether the laws applicable to governmental plan investors could extend to the hedge fund.

The safe harbor also does not cure prohibited transactions that arise from subscribing to the hedge fund. For example, a prohibited transaction exists if the seller of the fund's interests is a "party in interest" to the BPI. Subscription materials will typically ask for a representation from the BPI that the subscription is either not a

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prohibited transaction or that such prohibited transaction is covered by an exemption. Another example of a potential prohibited transaction is when principals of the fund sponsor wish to invest their IRAs in the fund. Irrespective of whether the fund holds "plan assets," such subscription gives rise to prohibited transaction concerns and should be addressed accordingly. The most likely approach to addressing that prohibited transaction is to waive all fees with respect to the IRA's investment in the fund.

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