PENSION PROTECTION ACT OF 2006 MAKES MAJOR CHANGES TO ERISA FIDUCIARY REQUIREMENTS

Showing strong bipartisan support, the House of Representatives, by a vote of 279-131, and the Senate, by a vote of 93-5, passed the Pension Protection Act of 2006 (the "Act"), which would dramatically change several longstanding fiduciary responsibility provisions of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). Of particular importance, the Act would:

- modify the so-called "25% benefit plan investor test" by counting toward the 25% limit only plans subject to ERISA or Section 4975 of the Internal Revenue Code (the "Code"), and specifying how the percentage is to be calculated when one fund invests in another;
- provide statutory exemptions with respect to (i) investment advice provided by a fiduciary to IRA holders and participants in participant-directed plans, and acquisitions and dispositions of securities or property resulting from such advice, (ii) certain transactions between plans and persons who are "parties in interest" by reason of being service providers to such plans, (iii) cross-trading and block trading, (iv) foreign exchange transactions, and (v) certain transactions executed on electronic communication networks ("ECNs");
- provide a statutory exemption from the bonding requirement for registered broker-dealers and raise the maximum bond for plans holding employer securities; and
- allow for a period to correct prohibited transactions in order to avoid imposition of excise taxes.

The Act awaits the President's signature in order to become effective.

The 25% Benefit Plan Investor Test

Under ERISA's plan asset regulations, generally, when a plan subject to ERISA or Section 4975 of the Code invests in nonpublicly offered equity interests of an entity engaged primarily in the investment of capital (e.g., a hedge fund), unless the participation by "benefit plan investors" is not "significant," the assets of the investing plan include not only its equity interest in the entity, but also an undivided interest in each of the assets of the entity. As a result, the assets of the entity become subject to ERISA fiduciary requirements. Under pre-Act rules, (i) "benefit plan investors" includes plans subject to ERISA and Section 4975 of the Code, as well as plans that are *not* subject to ERISA, including governmental plans, church plans, and foreign plans ("Non-ERISA Plans"), and (ii) participation of benefit plan investors is deemed to be significant to the extent that benefit plan investors hold 25% or more of any class of equity securities of the entity.

The Act would modify the definition of benefit plan investors to exclude Non-ERISA Plans, so that only plans subject to ERISA and Section 4975 of the Code would count toward the 25% limit. This modification could allow many private investment funds to accept significantly greater investment from pension plans without becoming subject to ERISA.

The Act would also provide that if a fund invests in a second fund, only the percentage of the assets of the investing fund attributable to benefit plan investors would count toward the 25% test for the second fund. For example, assume that investments by benefit plan investors represent 50% of the assets of a fund, and the fund invests $100 million in the only class of equity of a second fund. For purposes of calculating the 25% limit of the second fund, only $50 million (50% of the $100 million) would count as benefit plan investor money.

In the same example under pre-Act rules, because participation by benefit plan investors in the investing fund exceeds 25%, 100% of its investment in the second fund (i.e., $100 million) would count toward the 25% test for the second fund. The new rule, therefore, together with the new definition of benefit plan investors, would allow more flexibility in master-feeder fund structures where a passive feeder fund exceeds the 25% limit, since only the percentage of investment by benefit plans in the feeder would count toward the 25% limit for the master fund. It would also benefit any "fund of funds" that is over the 25% limit, since the underlying funds in which it invests will no longer need to count 100% of the investment of such fund of funds as assets attributable to benefit plan investors.

The Act would retain the current law's requirement that the 25% limit be observed with respect to "each class" of equity interests issued by a fund.

In addition to its operational impact on investment funds, the Act would require fund sponsors to update ERISA disclosure in their existing offering memoranda and subscription documents so as to comport with the new rules.

Investment Advice Exemption

Under pre-Act rules, plan advisors that are fiduciaries (e.g., by reason of providing "investment advice" to participants) are generally prohibited from using their fiduciary authority to cause a plan or IRA to engage in transactions (e.g., sales of products or services for a fee) with themselves or their affiliates.

The Act would provide an exemption from this rule, effective as of December 31, 2006, that would permit plan fiduciaries to provide investment advice to IRA holders and plan participants that results in transactions between the IRA or plan and the fiduciary or one of its affiliates, as well as the receipt of fees by such fiduciary or affiliate in connection with such transactions. The advice must be provided under an "eligible investment advice arrangement," which is an arrangement authorized by an independent plan fiduciary in which the fees received by the fiduciary advisor do not vary depending on the basis of any investment election option selected. For plans covered by ERISA (i.e., plans other than IRAs or Keogh plans), the advice may be generated by a computer model that utilizes objective criteria and meets certain other specific

requirements.[1] Fiduciary advisors would also be subject to detailed and specific disclosure requirements relating to, among other things, their affiliations with investment options, compensation and fees, and types of services they provide.

Service Provider Exemption

Under pre-Act rules, persons that provide services to a plan are considered "parties in interest" to the plan and are prohibited from engaging in most types of transactions with the plan, absent a specific exemption. At present, most day-to-day party-in-interest transactions can be exempted through use of the "QPAM exemption," under which fiduciary advisors meeting certain requirements can avail themselves of broad prohibited transaction relief.

The Act would provide a blanket exemption for any transaction involving the purchase or sale of securities or other property (but not services, goods, or facilities) between a plan and a person that is a party in interest by reason of being a service provider to the plan if (i) the plan receives no less, and pays no more, than "adequate consideration," in connection with the transaction (which, for exchange-traded securities, is generally defined to mean the applicable exchange-traded price, or the offer price on markets that are not exchanges), and (ii) the transaction does not relate to employer securities or employer real property.

Cross Trading and Block Trade Exemptions

In order to alleviate difficulties with certain types of customary trading activities, the Act would provide exemptions for certain cross trading and block trading transactions. Cross trading, under pre-Act rules, was prohibited due to ERISA's prohibition against a fiduciary's representing adverse parties in a transaction.

The Act would provide an exemption for cross trading transactions if (i) the transaction is a purchase or sale, for no consideration other than cash payment against prompt delivery, of a security for which market quotations are readily available, (ii) the transaction is effected at the independent market price of the security, (iii) no broker commission, fee, or other remuneration (except for customary transfer fees) is paid in connection with the transaction, (iv) a fiduciary for each plan authorizes the transaction in advance, (v) each plan participating in the transaction has assets of at least $100 million, (vi) the investment manager provides a quarterly report detailing all cross trades, (vii) the investment manager does not base its fee schedule on the plan's consent to cross trading, (viii) the investment manager adopts a cross trading policy that is fair and equitable to all accounts, and (ix) the investment manager designates an individual responsible for periodically reviewing all cross trades and issuing an annual report.

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[1] Advice generated by a computer model with respect to IRAs and Keogh plans will be subject to different requirements.

The Act would also provide an exemption for block trades between a plan and a party in interest (other than a fiduciary) if (i) the interest of the plan does not exceed 10% of the aggregate size of the block trade, (ii) the terms of the transaction are at least as favorable to the plan as those of an arm's-length transaction with an unrelated party, and (iii) the compensation associated with the purchase and sale is not greater than the compensation associated with an arm's-length transaction with an unrelated party. In order to qualify as a "block trade," the trade must be for at least 10,000 shares or have a market value of at least $200,000, which will be allocated across two or more unrelated client accounts of a fiduciary.

Foreign Exchange Transaction Exemption

Although other exemptions exist for foreign exchange transactions between plans subject to ERISA (other than IRAs and Keogh plans) and nonfiduciaries, the Act would provide specific relief for foreign exchange transactions between a bank or broker-dealer and a plan if (i) the transaction is in connection with the purchase, holding, or sale of securities or other investment assets, (ii) the terms of the transaction are not less favorable to the plan than the terms generally available in comparable arm's-length transactions between unrelated parties, (iii) the exchange rate used does not deviate by more than 3% from the interbank bid and asked rates for transactions of comparable size and maturity, and (iv) the bank or broker-dealer does not have investment discretion or provide investment advice with respect to the transaction.

Electronic Communication Network Exemption

In order to address possible prohibited transactions relating to trading through an ECN, the Act would provide an exemption for any transaction executed through an ECN, alternative trading system, or similar execution system or trading venue subject to regulation and oversight by a domestic or foreign regulatory agency if (i) either (a) the transaction is effected pursuant to rules designed to match purchases and sales at the best price available, or (b) neither the execution system nor the parties to the transaction take into account the identity of the parties in the execution of trades, (ii) the price and compensation are no greater than the price and compensation associated with an arm's-length transaction with an unrelated party, and (iii) the use of such network or systems is authorized in advance by an independent plan fiduciary.

Bonding Requirements

The Act would, for plan years beginning after December 31, 2007, increase the maximum bond for each fiduciary who handles funds or other property of a plan from $500,000 to $1 million. It would also exempt from the bonding requirement registered broker-dealers that are subject to the fidelity bond requirements of a self-regulatory organization.

Correction Period to Avoid Excise Tax

The Act would permit corrections of inadvertent prohibited transactions that occur in connection with the acquisition, holding, or disposition of any security or commodity, if such correction is made within the 14-day period beginning on the date on which a fiduciary or party in interest (or

other person) discovers, or reasonably should have discovered, that the transaction constituted a prohibited transaction. This relief would not be available (i) to prohibited transactions involving employer securities, (ii) where the fiduciary or party in interest knew of the violation at the time the transaction was executed, or (iii) for breach of fiduciary self-dealing rules.

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