SIMPSON THACHER

Pension Protection Act of 2006 - Plan Assets and Prohibited Transaction Matters

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As you may be aware, the Senate and the House have now both passed the Pension Protection Act of 2006 (the "Act"). As described below, the Act makes some helpful changes to the ERISA "plan asset" rules for private equity funds (including hedge funds), and adds new prohibited transaction exemptions all of which may provide substantial relief to private equity funds that are operated as ERISA plan asset funds. It may also substantially reduce the pressure on other private equity funds that are forced to comply with the burdensome requirements necessary to qualify as a "venture capital operating company" (a "VCOC") or a "real estate operating company" (a "REOC").

The Act also addresses a number of other issues under ERISA relating to various types of pension plans (including funding, distribution and disclosure requirements), the legality of cash balance plans, and certain welfare benefits which, together with the plan asset and prohibited transaction matters discussed herein comprise the bulk of the law. We expect to send a broader ST&B firm client memorandum in the near future that will provide you with a more comprehensive overview of the Act and the areas it addresses. However, we thought it was very important that we highlight certain plan asset and prohibited transaction aspects of the proposed new law for you on an expedited basis given how critical these issues are to the business of many of our clients.

A. Plan Assets.

The Act would have a dramatic impact on the rules governing when the assets of a private investment fund would be considered "plan assets" of a plan subject to Title I of ERISA or Section 4975 of the Internal Revenue Code.

1. Background. When a plan subject to Title I of ERISA or Section 4975 of the Internal Revenue Code (each, an "ERISA Plan") acquires an equity interest in an entity (an "Investment Fund") that is neither a "publicly-offered security" nor a security issued by an investment company registered under the Investment Company Act of 1940, the ERISA Plan's assets will be deemed to include not only the equity interest itself, but also an undivided interest in each of the underlying assets of the Investment Fund, unless the Investment Fund either operates as a VCOC or an REOC, or the Investment Fund at all times satisfies the 25% Test.

For purposes of the 25% Test, the assets of an Investment Fund would not be considered "plan assets" and the sponsor would not be subject to the fiduciary responsibility or prohibited transaction rules of ERISA or the Internal Revenue Code if, at all times, less than 25% of the value of each class of equity interests of the Investment Fund are held by "benefit plan investors."

Under the current law, "benefit plan investors" is broadly defined to include all employee benefit plans, even those plans that are not subject to Title I of ERISA or Section 4975 of the Internal Revenue Code, such as governmental plans and pension plans maintained by non-US corporations.

Further, under the current law, if 25% of any class of equity of an entity is held by "benefit plan investors" (broadly defined), unless the entity satisfies another exception, 100% of the entity's assets are considered "plan assets." Accordingly, when calculating the 25% Test under the current law, an Investment Fund would have to include as benefit plan money 100% of the investment by an investing entity (such as a fund of funds) whose underlying assets are deemed to include "plan assets."

2. Proposed Change. The Act makes two significant revisions to the 25% Test:

(i) Under the Act, the term "benefit plan investors" for purposes of applying the 25% Test is limited to include only those plans that are subject to Title I of ERISA or Section 4975 of the Internal Revenue Code. Non-ERISA plans, such as governmental pension plans and non-U.S. pension plans, would no longer count for purposes of the 25% Test.

(ii) Under the Act, an entity will be considered to hold plan assets only to the extent of the percentage of the equity interests that are held by "benefit plan investors" (as redefined) of such entity.

3. Planning Opportunities. Depending on the Investment Fund's investor base as well as its governing documents, disclosure and any side letter agreements, the revised 25% Test may offer more flexibility to an Investment Fund. For example:

(i) An Investment Fund relying on the 25% Test may have additional capacity to accept more benefit plan investors into the Investment Fund, including governmental plans, non-US pension plans and ERISA Plans, and still be able to satisfy the 25% Test.

(ii) An Investment Fund that is currently operating as a "plan assets" fund subject to the fiduciary and prohibited transaction provisions of ERISA may prospectively be able to satisfy the 25% Test and operate without having to abide by these ERISA restrictions.

(iii) An Investment Fund that relies on the VCOC or REOC exception because it does not satisfy the 25% Test under current law, may satisfy the 25% Test as revised under the Act. Since the VCOC and REOC exceptions impose significant restrictions on the manner in which investments are made as well as stringent ongoing compliance obligations, the 25% Test as revised under the Act could give the Investment Fund more flexibility regarding the manner in which it makes its investments without imposing any additional constraints on the Investment Fund's investor base.

Each Investment Fund should review its partnership agreement, subscription documents and side letter agreements to determine whether changing from the VCOC or REOC exception to the 25% Test is permissible. If an Investment Fund has committed itself to operate as a VCOC or REOC, but it now will have the ability to satisfy the 25% Test as revised under the Act, then an evaluation should be done to see if the Investment Fund can amend the partnership agreement or other operative documents, and whether limited partner consent would be needed for such an amendment.

Further, sponsors of Investment Funds should review relevant fund documents to determine whether any governmental or non-US pension plan investors have asked to be contractually treated as a plan subject to ERISA for purposes of the partnership agreement, and to evaluate whether any such agreement would impact the Investment Fund's ability to rely on the 25% Test as revised by the Act.

B. PROHIBITED TRANSACTION EXEMPTIONS.

The Act provides additional relief which may be useful to fund managers operating an ERISA “plan assets” investment fund (i.e., an investment fund which does not meet any of the aforementioned exceptions under the ERISA regulations and which has ERISA Plan investors (a “Plan Assets Fund”)).

1. Background. To address fiduciary misconduct, Title I of ERISA and Section 4975 of the Internal Revenue Code generally prohibit a wide range of transactions (including sales, exchanges, leases, loans and transfers) between a plan and a “party in interest” to the plan, unless a “prohibited transaction exemption” applies.

One widely used exemption, and the one that most managers of a Plan Assets Fund attempt to rely upon, is the exemption for transactions involving a “qualified professional asset manager,” commonly referred to as a “QPAM.” The QPAM exemption involves detailed and sometimes burdensome requirements.

The Act provides new relief in the form of (i) a new service provider statutory exemption which would exempt many transactions between a service provider and a plan and (ii) a new statutory exemption permitting a manager of a Plan Asset Fund to effect securities trades between managed accounts under rules that are similar to those that apply to mutual funds. Each of these new exemptions will have a significant positive effect on the ability of a manager of a Plan Asset Fund to complete many transactions more freely.

2. Service Provider Exemption. The Act would generally exempt transactions between a plan and a service provider (and persons related to the service provider) if: (i) the transaction is not a provision of services, goods or facilities, (ii) the transaction is not an acquisition or disposition of employer securities or employer real property, (iii) the plan neither receives less, nor pays more, than "adequate consideration" in the transaction and (iv) neither the person transacting with the plan nor any of its affiliates is a fiduciary who has or exercises any discretionary authority or control with respect to the investment of the plan assets involved in the transaction or renders investment advice with respect to those assets.

Disclosure and compliance procedures restricting transactions between a Plan Assets Fund and financial institutions could be substantially simplified since the proposed service provider exemption would be likely to displace reliance on the QPAM exemption in many circumstances.

3. Cross Trading Exemption. Generally speaking, unless the Department of Labor has granted an individual exemption, or the trade is index-or model-driven and otherwise satisfies a specific class exemption, trades between two accounts advised by the same adviser are per se prohibited.

The Act would permit an investment manager to cause its advised accounts to trade with each other so long as:

> (i) the transaction is a purchase or sale for no consideration other than cash against prompt delivery of a security for which market quotations are readily available, (ii) the transaction is effected at the independent current market price of the security (within the meaning of Rule 17a-7(b) under the Investment Company Act), (iii) no brokerage commission, fee (except for customary transfer fees previously disclosed) or other remuneration is paid in connection with the transaction, (iv) a fiduciary (other than the 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 polices on cross trading, (v) each plan (or master trust of related plans) involved has assets in excess of $100 million, (vi) the manager provides a quarterly report to the fiduciary detailing all cross trades executed by the manager for the plan involved 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, (vii) the manager does not base its fee schedule on the plan's consent to cross trading, and no other service is conditioned on the plan's consent to cross trading and (viii) the manager has policies and procedures in place that allocate cross trades in an objective manner among all accounts participating in the cross trading program.

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If the Act is enacted into law, as expected, reliance on the new law will be permitted for future transactions immediately upon adoption. However, we anticipate that the Department of Labor will ultimately issue regulations interpreting the new law. We will continue to update you with any further developments.

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