

ERISA and Investment Funds

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The Employee Retirement Income Security Act of 1974 (ERISA), and its amendments, were generally enacted to protect individuals enrolled in private, voluntarily established pension plans. ERISA, as amended, requires the furnishing of information to beneficiaries and imposes fiduciary duties on those who manage plan assets. If you are an investment manager or general partner/managing member of an investment fund that has employee benefit plans as investors, you may be subject to ERISA.

Who is a Fiduciary?

A fiduciary is any person who (i) exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets; (ii) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so; or (iii) has any discretionary authority or discretionary responsibility in the administration of such plan.

Generally, an investment advisor will fall under at least one, if not all, of the requirements above. However, the above definition is only applicable if an adviser is deemed to exercise control over "plan assets."

What are Plan Assets?

"Plan assets" include the assets of any entity (e.g., partnership, corporation, or trust) in which a plan has an equity interest. The assets of an investment fund would generally be considered plan assets if an employee benefit plan has an equity interest in the investment fund. These look-through provisions are especially important to funds of funds. However, there is an exception for an entity in which the participation of "benefit plan investors" is not "significant."

Prior to the enactment of the Pension Protection Act of 2006 (2006 Pension Act), benefit plan investors included not only private pension and welfare benefit plans

covered by Title I of ERISA, but also IRAs, Keogh plans, governmental plans, church plans, foreign plans, and any entity whose underlying assets include plan assets by reason of a plan's investment in the entity. The 2006 Pension Act excluded governmental and foreign plans from the types of plans that are considered "benefit plan investors."

Participation by benefit plan investors is significant, if immediately after the most recent acquisition of any equity interest in the entity, such investors hold 25% or more of the value of any class of equity interests. Any interests held by a person who has discretionary authority or control over the assets of the entity (such as the general partner of a partnership) or who renders investment advice for a fee with respect to such assets (or any affiliate of such a person) is not included when calculating the 25% threshold.

Prior to the enactment of the 2006 Pension Act, an entity was considered to hold plan assets to the full extent of the equity interest in any partnership that had 25% or more of the value of any class of equity interest held by benefit plan investors. For example, suppose Fund A had an investment of \$1,000,000 in Fund B and the equity interest from benefit plan investors in Fund B was 30%. Since Fund B had exceeded the 25% or more threshold, all of Fund A's investment in Fund B, \$1,000,000, was considered as part of Fund A plan assets.

With the enactment of the 2006 Pension Act, an entity is considered to hold plan assets only to the extent of the percentage of the equity interest held by benefit plan investors. In the above example, Fund A would only have to consider \$300,000 (\$1,000,000 investment x 30%) of its investment in Fund B as plan assets.

What are the Fiduciary Duties?

Fiduciaries have legal duties imposed by ERISA. Fiduciaries must act in accordance with what is commonly referred to as the "prudent person rule," which

means that a fiduciary's actions will be compared against those of a hypothetical prudent person. A fiduciary must give "appropriate consideration" to the facts and circumstances that the fiduciary knows or should know are relevant to a particular investment, including the role that the investment plays in the plan's investment portfolio. Consideration should also be given to (i) the diversification of the investment portfolio; (ii) the liquidity of the investment in relation to the liquidity needs of the plan; and (iii) the projected investment return in relation to the funding objectives of the plan.

A fiduciary must consider the diversification of the investments of a plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. A fiduciary should consider: (i) the purpose of the plan; (ii) the size of the investment; (iii) economic and market conditions; (iv) the type of investment — debt or equity; (v) the geographic dispersion of investments; (vi) the investment distribution among industries; and (vii) the dates of maturity.

A fiduciary should also act in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of ERISA.

Finally, no fiduciary may maintain the indicia of ownership of any assets of a plan outside the jurisdiction of the district courts of the United States.

What are the Fiduciary Liabilities?

Any fiduciary that breaches any of the responsibilities, obligations, or duties is personally liable to make good to such plan and any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary. Recovered losses may include the difference between the plan's actual earnings and what it could have earned absent the breach. A fiduciary may also be subject to criminal penalties including fines and jail time.

Why become a Registered Investment Adviser?

If you are a general partner/managing member of an investment fund or investment adviser who becomes a fiduciary, being a Registered Investment Adviser (RIA) could be important to the trustees of the investing plans, because the trustees of the plans could be exempt from fiduciary liability with respect to the RIA's advisory role. If you are not a RIA, the trustees of the investing plans could be fully liable for any breaches committed by you as fiduciary. However, if you are a RIA, the trustees of the investing plans can appoint you as investment manager, which you will have to acknowledge your fiduciary duties to the investing plans in writing. Once you are appointed as investment manager, the trustees of the investing plans are simply under a duty to act prudently in appointing you as the investment manager and monitoring you to ensure you act in the interests of the investing plans.

If you are not a RIA then you cannot be an investment manager. The trustees of the investing plans would therefore be fully liable for any fiduciary breaches of adviser, which may lead the trustees to invest elsewhere. ©

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The above summary briefly describes the basics of the interaction between investment funds and employee benefit plans and is not intended to be applicable to any individual investment or tax situation. We suggest that each taxpayer consult his or her tax or legal advisor.
