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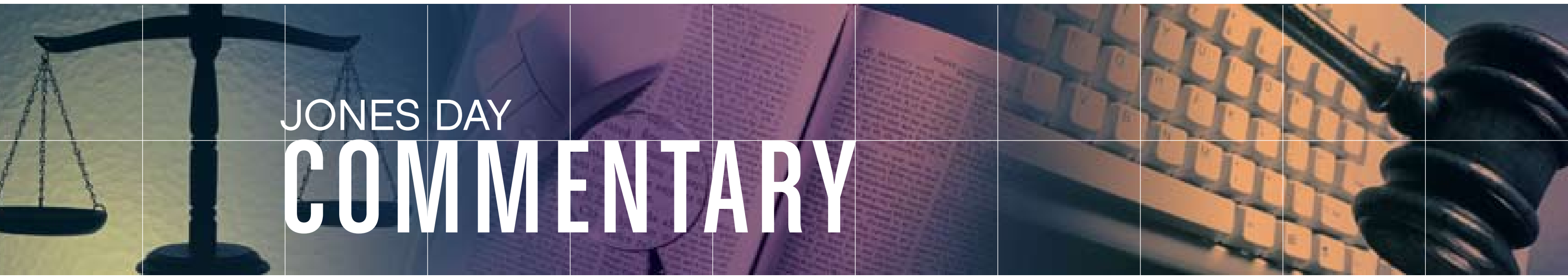

PENSION PROTECTION ACT BROADENS OPPORTUNITIES FOR INVESTMENT FUNDS

The Pension Protection Act of 2006 ("PPA") revised the technical rules defining "plan assets" that are subject to the Employee Retirement Income Security Act ("ERISA"). These changes expand the types of investors that safely can be allowed to purchase interests in pooled investment funds, including trusts and limited partnerships (such as hedge funds), without subjecting the funds to ERISA's fiduciary restrictions. For transactions occurring after the signing of the PPA by President Bush on August 17, 2006, investments by governmental plans, non-U.S. plans, and most church plans no longer affect the application of ERISA to the assets of these funds.

ERISA PLAN ASSET RULES

The definition of "plan assets" in a regulation issued by the Department of Labor restricts the sources of funds for most pooled investment funds. Under this regulation, unless an exception applies, when an employee benefit plan subject to ERISA purchases an equity interest in another entity, a "look-through rule" applies and the plan's assets include both the equity interest *and an undivided interest in the entity's underlying assets*. As a result, unless there is an exception, the entity's assets are subject to ERISA and the manager of the entity is a fiduciary and has to follow ERISA's fiduciary rules in operating the entity. Since these fiduciary rules could substantially restrict or complicate common commercial transactions engaged in by most investment funds, qualifying for an exception from this look-through rule has been crucial to the ability to access the trillions of dollars of plan assets through the sale of equity interests.

Private equity funds, venture capital funds, and real estate funds have been able to take advantage of the venture capital operating company ("VCOC") or real estate operating company ("REOC") exceptions to the look-through rule. However, most other private funds (principally hedge funds) can only avail themselves of the exception where participation by "benefit plan investors" is not significant. Therefore, such funds have had to limit investments by benefit plan investors to less than 25 percent of the fund's equity interests.

PPA BROADENS ACCESS TO CAPITAL FOR HEDGE FUNDS

The PPA significantly broadens this "significant participation" exception in two ways, making it more available as a means to avoid the look-through rule:

1. As noted above, investments by governmental plans, non-U.S. plans, and most church plans, which previously were benefit plan investors as defined by the plan asset regulation, no longer count in determining whether the 25 percent threshold has been exceeded. Now, the "benefit plan investor" definition has been amended, and only plans subject to ERISA's fiduciary rules, IRAs, and other arrangements subject to section 4975 of the Internal Revenue Code ("Code") and entities whose assets include plan assets by reason of a plan's investment in the entity are included. Consequently, existing funds may be able to accept additional investments from these benefit plan investors, and new funds may be able to increase the investments they expect to receive from benefit plans of all types, without exceeding the 25 percent threshold.

2. A proportionate rule that previously applied only to insurance company general accounts now applies in all cases, which will be particularly useful in the case of investments by feeder funds or funds of funds. Under this rule, if more than 25 percent of an investor's equity interests are held by benefit plan investors, only a proportionate amount of its investment in an entity counts towards the entity's 25 percent threshold (but if less than 25 percent of the investor's equity interests are held by benefit plan investors, none of the investor's investment counts). Previously, once the 25 percent limit was exceeded, the entire investment counted for purposes of the significant participation exception. Depending on the composition and characteristics of its investors, this proportionate rule may increase the investments that a fund can accept without exceeding the 25 percent threshold.

PRIVATE EQUITY, VENTURE CAPITAL, AND REAL ESTATE FUNDS

The exclusion of governmental plans, non-U.S. plans, and most church plans from the definition of "benefit plan investor," while designed to aid the hedge fund industry, will also have an impact (though less significant) on private equity, venture capital, and real estate funds. Because these funds already could qualify for an operating company exception to the look-through rule, they have been able to raise money from benefit plans without regard to the 25 percent threshold. Nevertheless, the PPA changes may allow some private equity, venture capital, and real estate funds to stay below the 25 percent threshold, which would provide an alternative exception to the look-through rule.

As a practical matter, private equity, venture capital, and real estate funds will need to continue to be structured to satisfy the operating company exceptions, since whether the fund will be above or below the 25 percent threshold will not be known until after the fund has been established. In addition, since fund sponsors generally begin negotiating portfolio investments, or even warehousing actual investments, before the final roster of investors is determined, a fund will need to continue to ensure that the structure, management rights, and other aspects of the fund's initial portfolio company investment satisfy the applicable VCOC or REOC requirements.

In addition, due to contractual obligations or investor requirements, many private equity, venture capital, and real estate funds will continue to comply with an operating company exception without regard to the 25 percent threshold. Many investors may demand the added layer of protection from compliance with the operating company rules, and lenders and other parties dealing with the funds may also require continued compliance. The operational rules of the operating company exceptions, although intricate, are well known, and funds and investors alike have become familiar with those requirements. In contrast, while the rules applicable to the calculation of the 25 percent limit (some of which are discussed below) are also complex, the problems and interpretive issues arising from monitoring the 25 percent threshold under the PPA-changed significant participation exception are new. For existing funds, partnership agreements and credit agreements may also require compliance with one of the operating company exceptions without regard to the 25 percent threshold. And for fund sponsors that are used to structuring investments to comply with the operating company rules, the added legal protection from such compliance may easily outweigh the time and cost involved.

POST-PPA, THE DEVIL IS STILL IN THE DETAILS

Although a significant amount of additional capital is now available, investment funds still must exercise caution in view of the myriad rules that remain applicable.

- The significant participation exception to the look-through rule must be tested whenever there is an acquisition of an investment fund's equity interests (including when there is a redemption of an investor, which is deemed to be an acquisition by the remaining investors). This means that funds that are relying on the 25 percent limit must be able to monitor the percentage ownership of investors that are themselves subject to the look-through rule in order to be able to accurately determine their own percentage ownership whenever there is an acquisition of an interest in the fund. For example, if the ownership of a fund of funds by benefit plan investors increases from 30 percent (at the time it acquired an interest in a hedge fund) to 35 percent (when another investor later acquires an interest in that hedge fund), the hedge fund must include the increase when confirming its own compliance with the 25 percent limit at the time of the later acquisition. In some cases, this administrative complication may mitigate to some extent any advantage resulting from the proportionate rule and, as noted above, may cause private equity, venture capital, and real estate funds to continue to rely on the operating company exceptions.

- In calculating the percentage ownership of an entity for purposes of the 25 percent threshold, equity interests held by certain managers of the entity and their affiliates are disregarded, which increases the proportion of benefit plan investor ownership. Evidently, these disregarded interests include those controlled (but not owned) by these managers. Funds that intend to seek investments from benefit plan investors should be sure to take this into account when structuring insiders' equity participation.

- Investment funds must still protect against prohibited transactions under ERISA and the Code when benefit plan investors acquire interests.

- Although governmental, non-U.S., and most church plans are not subject to ERISA, it is still necessary for investment funds to ensure that acquisitions of interests by these plans comply with any state, local, or foreign laws that do apply to them and regulate their investments.

- Notwithstanding the PPA changes, private investment funds that cannot monitor the composition of the ownership of their equity interests (*e.g.*, funds using book entry registration and global notes registered in the name of the Depository Trust Company or its nominee) will still need to prohibit sales or transfers of equity interests to benefit plan investors in order to avoid the look-through rule. Such funds, however, will be able to permit governmental, non-U.S., and most church plans to acquire these interests without having to be concerned about the impact of such acquisitions on the 25 percent threshold should a benefit plan investor happen to acquire an interest. Of note, however, the PPA did not provide any additional guidance on what is "equity" and what is "debt" for purposes of the ERISA plan asset rules.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Jeffrey S. Leavitt
1.216.586.7188
jleavitt@jonesday.com

Alan S. Miller
1.212.326.3445
1.214.969.4559
asmiller@jonesday.com