

THE GLOBAL REACH OF ERISA

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ERISA plans should take note that when they invest in pooled funds that are not U.S. registered, they may encounter serious complications under the fiduciary provisions of ERISA. Pooled investment funds registered in other countries and the financial institutions that serve them as trustees, investment managers and advisors may also find themselves entangled in ERISA-related complications.

When an ERISA plan invests in a mutual fund that is registered under the Investment Company Act of 1940, the mutual fund shares are considered plan assets under ERISA, but the underlying investments made by the mutual fund are not deemed to be plan assets. Equity interests in some other entities, such as interests in partnerships, undivided interests in property, and beneficial interests in trusts, are accorded similar treatment under the plan asset regulations if the equity interests are publicly offered securities. To be a publicly offered security, the security must be registered under the U.S. securities laws and meet other regulatory criteria. In addition, through its prohibited transaction exemption process, the Department of Labor has granted similar status to various types of pooled investment vehicles.

However, pooled investment vehicles that are registered outside of the United States do not receive the same treatment under ERISA. Consequently, if an ERISA pension plan buys equity interests in a pooled fund not registered in the U.S., not only will the shares or units of the fund be classed as plan assets, but, in addition, the underlying assets held by the fund may also be considered plan assets for purposes of ERISA. The consequences of this look-through treatment are onerous, because discretionary management and control of plan assets, and advising on investment of plan assets for a fee trigger fiduciary status under ERISA.

Look-through treatment may be avoided if the equity participation in the pooled fund entity by “benefit plan investors” is not “significant”. ERISA regulations define “significant” as “25 per cent or more of the value of any class of equity interests in the entity”. Under ERISA and the plan asset regulations, a benefit plan investor may be almost any employee welfare benefit plan and employee pension benefit plan whether or not the plan is subject to ERISA, U.S. trusts that are part of qualified pension annuity plans or are otherwise defined under Section 4975(e)(1) of the Internal Revenue Code, and individual retirement accounts or annuities. Also included in the “benefit plan investor” definition is “(a)ny entity whose underlying assets include plan assets by reason of a plan’s investment in the entity”. Examples of this type of entity are certain insurance company separate accounts and bank collective investment funds. A PWBA spokesperson indicated that this definition is broad enough to include foreign pension plans, as well as U.S. plans, regardless of whether the plans are private or public. All of these plan types are aggregated in calculating the 25 per cent threshold for a significant investment.

Thus, any non-U.S. pooled fund, such as an investment trust, a management company, or a unit trust, must restrict its benefit plan investors from anywhere in the world to less than 25% of the value of any class of interests it issues, or all of its assets become plan assets under ERISA. Any person who has discretionary authority to manage and control plan assets or who receives a fee for giving investment advice regarding plan assets becomes a fiduciary under ERISA. An ERISA fiduciary is heavily regulated and subject to various penalties and liabilities. Thus, the foreign investment manager or adviser, or the trustee of a pooled fund would be subject to the provisions of ERISA, including the duty to manage the fund prudently and in the interest of the pension plan participants, the duty to maintain the indicia of ownership of the plan assets

in accordance with ERISA section 404(b), and the obligation to comply with the prohibited transaction rules in section 406.

Given the specific and restrictive nature of these ERISA provisions, the foreign fiduciary will almost certainly violate them. At present, it seems quite unlikely that the U.S. Department of Labor would attempt to impose liability on a foreign investment manager, trustee or adviser.

However, through the co-fiduciary liability provisions of ERISA and because the foreign fiduciary is not an investment manager as defined in ERISA, the U.S. fiduciary of the pension plan would become responsible for the actions of the foreign fiduciary and liable for them. The U.S. fiduciary would be exposed not only to actions by the Department of Labor, but also to actions by plan participants and other co-fiduciaries. In addition, the U.S. fiduciary would itself have to comply with the prohibited transactions rules (especially 406(a)), and the general fiduciary duties of sec. 404. Violation of some aspect of ERISA is, under these circumstances, almost inevitable.

In principle, if a U.S. ERISA fiduciary wants to invest in a foreign pooled investment instrument, it should take steps to assure that the foreign fund will not have 25% or more of its value owned by benefit plan investors, as defined in the plan asset regulations. Similarly, foreign investment funds that wish to attract ERISA investors should institute measures to prevent the aggregate investment by benefit plan investors from reaching the 25% threshold. In practice, this type of monitoring would be very costly, and nearly impossible to implement.

Benefit plan investments are typically held by custodian banks in nominee names that do not reveal the identity of the investor. Plan investments may be held in custodians' omnibus accounts, together with assets of non-benefit plan investors. Efforts by foreign pooled funds to inquire into the identity of custodian bank clients would be refused on the basis of client confidentiality. Consequently, even if the ERISA fiduciary or the foreign pooled fund sought to monitor the percentage of benefit plan investment, it would not be able to do so. Of course, these same factors would make it difficult for the PWBA to prove that the 25 per cent threshold has been exceeded.

Nevertheless, foreign pooled funds marketing themselves to pension funds would very likely find that their efforts to attract U.S. pension fund investments will be impeded by this situation. U.S. pension fund investors seeking to invest abroad may be reluctant to invest in such foreign funds, even though foreign funds might otherwise be a prudent and advantageous way of obtaining the benefits of foreign investments for their plans.

The foreign pooled fund aspect of the plan asset regulations may raise problems in other contexts as well. Take the example of a master fund registered in Luxembourg, with feeder funds registered in the Cayman Islands. If one of the feeder funds is a fund structured for ERISA and other pension fund investments, it will be a fund with more than 25% of its investments derived from benefit plan investors. Consequently the shares or units of the feeder fund will be plan assets, and so will the underlying investments of the feeder fund. Typically, those underlying investments will be shares or units of the master fund. If the benefit plan feeder fund holds less than 25% of the assets of the master fund, the process of looking through to underlying investments will stop there. If the feeder holds more than 25% of the units of the master fund, then very likely, the underlying assets of the master fund will also be considered plan assets under ERISA.

Other ramifications remain to be explored. Suppose, for example, that the master and the feeder funds have interlocking directors, as they usually do. The directors of the feeder fund might be ERISA fiduciaries with

the duty to manage and control plan assets in the best interest of the plan beneficiaries. Further research is needed to develop the legal issues regarding this and other situations.