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VIA E-MAIL

To Our Investment Adviser Clients and Other Friends:

Re: New Law Changes Rules on Management of ERISA Plan Assets

The Pension Protection Act of 2006 (the “Act”), enacted on August 17, 2006, is the most comprehensive federal pension reform legislation in years, affecting a wide range of subjects. Among other things, the Act changes several provisions of the Employee Retirement Income Security Act of 1974 (“ERISA”), that affect an investment adviser’s management of accounts that include assets of plans covered by ERISA Title I (“ERISA Plans”). The changes:

- Amend ERISA’s “plan asset” rules to reduce the types of investments taken into account in determining if a hedge fund’s assets are “plan assets” (although a proposal to increase the “plan assets” threshold to fifty percent was not enacted);
- Add new exemptions from the “prohibited transaction” restrictions of ERISA and the Internal Revenue Code (the “Code”); and
- Exempt brokers (but not investment advisers) from ERISA’s bonding requirements, and increase the bond limit when a plan holds employer securities.

Except as otherwise noted, these changes apply to transactions occurring after August 17, 2006.

Changes to “Plan Asset” Rules. Department of Labor (“DOL”) regulations under ERISA provide that, absent an applicable exception, the assets of an entity (such as a hedge fund) are “plan assets” of its ERISA Plan investors if, after the most recent acquisition or disposition of any equity interest in the entity, twenty-five percent or more of the value of any class of its equity interests is held by “benefit plan investors.” Whenever an investment adviser has a client (including a hedge fund) whose assets are “plan assets,” the adviser is a fiduciary to the ERISA Plan investors in the client and thus must comply with ERISA’s fiduciary requirements, and transactions involving the client are subject to the prohibited transaction rules of ERISA and the Code. Investment pools (including hedge funds) often opted to stay below the twenty-five percent threshold to

avoid these consequences. Under the now-superseded regulations, “benefit plan investors” included ERISA Plans, foreign plans, governmental plans, church plans, individual retirements accounts (“IRAs”), pension plans covering only owner-employees, and “funds of funds” whose assets are themselves “plan assets” by application of the regulations. The Act changes the twenty-five percent calculation in two ways:

- foreign plans, governmental plans and certain church plans are now excluded from the definition of “benefit plan investor,” so their interests no longer count toward the twenty-five percent threshold; and
- a fund of funds whose assets are themselves plan assets will be considered to hold plan assets in the entity only to the extent of equity interests held in it by benefit plan investors. For example, if benefit plan investors hold thirty percent of the equity interests in a fund of funds whose equity interest in a hedge fund is \$20,000,000, only \$6,000,000, instead of the entire \$20,000,000, is deemed owned by benefit plan investors for purposes of the hedge fund’s twenty-five percent calculation.

Because of the new calculation method, an adviser should obtain updated representations from clients and investors in its hedge funds to identify the percentage of such clients and investors comprising benefit plan investors. An adviser to a hedge fund will also need to require the investors in the fund to report each change in their benefit plan ownership percentages, because a change will affect the calculation of the hedge fund’s own twenty-five percent calculation.

New Prohibited Transaction Exemptions. To prevent self-dealing by plan insiders, ERISA prohibits fiduciaries (such as investment advisers to ERISA Plans and hedge funds with at least twenty-five percent benefit plan investor participation) from causing a plan to engage in certain transactions with a “party in interest”. The Code imposes an excise tax on any “disqualified person” (which is generally the same as a party in interest) who engages in a prohibited transaction with a plan. An adviser who is a fiduciary of an ERISA Plan is liable to the ERISA Plan for losses caused by the prohibited transaction, and may also be liable by contract to the disqualified persons that must pay the excise tax. Some transactions that would otherwise be prohibited, however, are exempted by the statutes or by DOL administrative exemptions. The Act added the following new exemptions, which we expect will have only limited utility for most advisers:

Transactions with Service Providers. An adviser that enters into securities transactions on behalf of a client that is subject to ERISA must ensure that such a transaction is not prohibited because the counterparty to the trade (such as the prime broker) is a “party in interest” to the client or to one of the ERISA Plan investors in the hedge fund that the adviser manages. This issue may arise, for example, in connection with swap transactions, securities lending arrangements and foreign exchange transactions, when the client enters into transactions directly with those counterparties (rather than through a public exchange). A qualified adviser may rely on the qualified

professional asset manager (“QPAM”) exemption, which provides a blanket exemption for many prohibited transactions, to enter into such transactions. An adviser may not, however, qualify as a QPAM or may be unwilling to represent to clients or investors that it is and will at all times be a QPAM. The Act provides a new exemption for certain transactions between a plan and a person who is a party in interest solely by virtue of providing services to the plan if:

- The party in interest is not a fiduciary (or an affiliate) who has or exercises any discretionary authority or control over investment of the assets involved in the transaction and is not a paid investment adviser with respect to those assets (thus, transactions between a hedge fund with at least twenty-five percent benefit plan investor participation and the investment adviser to one of the ERISA Plan investors in such hedge fund (or an affiliate thereof) remains a prohibited transaction); and
- The plan receives no less, and pays no more, than adequate consideration. “Adequate consideration” is:
 - for a security traded in a generally recognized market, its prevailing price on a registered national securities exchange, taking into account factors such as the size of the transaction and the marketability of the security;
 - for any other security, a price not less favorable to the plan than the security’s offering price, as established by the current bid and ask prices quoted by a person independent of the issuer and the party in interest, taking into account factors such as the size of the transaction and the marketability of the security; and
 - for any other asset, its fair market value as determined in good faith by a fiduciary (such as the adviser) in accordance with DOL regulations.

If these requirements are met, an adviser may now cause a plan client to enter into swap, foreign currency and securities lending transactions with an affiliate of a non-fiduciary custodian under circumstances that would have been prohibited under pre-Act rules.

Cross Trades. Cross trades that an adviser makes directly (that is, not in an arm’s length transaction) between an account with plan assets (such as a fund that reaches the twenty-five percent “benefit plan investor” threshold) and another account managed by the same adviser can be a prohibited transaction, because the adviser is acting on behalf of both seller and buyer. An adviser must ensure that any rebalancing cross-trade in which a plan client participates is not a prohibited transaction. Advisers have in the past sought relief from the DOL regarding such cross-trades, but the DOL has exempted cross trades only in limited circumstances.

The Act provides broader relief for cross trades between a plan client and an adviser's other clients. This relief is, however, subject to significant conditions that will limit its usefulness for most advisers, including (among others):

- Each plan participating in the transaction must have assets of at least \$100,000,000. Thus, an adviser to a hedge fund with at least twenty-five percent benefit plan investor participation must ensure that each of those benefit plan investors has assets of at least \$100,000,000. An adviser to other plan clients must ensure that each such client has assets of at least \$100,000,000.
- A fiduciary (other than the adviser engaging in the cross trade or an affiliate thereof) for each plan participating in the transaction must provide the adviser with advance authorization to engage in cross trades in the adviser's discretion after the adviser has fully disclosed to the fiduciary the conditions under which the adviser would effect cross trades, including any of the adviser's written policies and procedures. Both the authorization and the disclosure must be in writing and must be separate from any other written agreement or disclosure. Thus, for a hedge fund adviser, disclosure in the hedge fund's offering circular and authorization in the hedge fund's agreement of limited partnership are insufficient because they are not in separate documents. Similarly, an adviser cannot incorporate the authorization in its investment management agreement with a separate account client.
- The manager reports to the authorizing fiduciary all cross trades in which the plan participates during each quarter.
- The manager implements cross trades according to written policies and procedures that are fair and equitable to all participating accounts, including the manager's pricing and objective allocation policies and procedures. The Act requires the DOL to adopt rules governing these policies and procedures.
- The manager has designated an individual responsible for periodically reviewing and annually reporting to the plan on compliance with those policies and procedures.

Block Trades. Advisers routinely enter into "block trades", which are trades advisers place with brokers or make directly with counterparties for multiple client accounts, which trades are then allocated among such accounts. An adviser will be permitted to effect a block trade of securities (or other property, such as futures contracts and currency, as may be determined by the DOL) between plan clients and brokers or other counterparties that are non-fiduciary parties in interest if:

- The block trade has of at least 10,000 shares with a market value of at least \$200,000 to be allocated among two or more unrelated client accounts;
- The interests of the plan (together with the interests of other plans of the same plan sponsor) do not exceed ten percent of the block trade;

- The price and other terms are at least as favorable to the plan as in an arm's length transaction; and
- The compensation associated with the transaction is no more than that in an arm's length transaction with an unrelated party.

Correction Period for Certain Prohibited Transactions. As noted above, disqualified persons are subject to significant excise taxes on prohibited transactions. An adviser that causes a plan client to effect a prohibited transaction is liable to those clients for losses caused thereby and may also be liable by contract to such disqualified persons. The Act allows inadvertent prohibited transactions in most securities or commodities to be cured without penalty, if they are corrected within fourteen days of the date the fiduciary, party in interest or other person knowingly participating in the transaction discovers, or reasonably should have discovered, that the transaction was prohibited. A transaction is "corrected" if it is undone to the extent possible and the plan or affected account is reimbursed its losses or paid its profits from the prohibited use of its assets. The exemption is not available if, at the time of the transaction, its prohibited nature was known or reasonably should have been known.

This exemption is effective with respect to transactions that, after August 17, 2006, were discovered, or reasonably should have been discovered, to have been prohibited.

Foreign Exchange Transactions. The DOL has previously exempted foreign exchange transactions between a plan and a party in interest that satisfied specified requirements. Under the Act, an adviser may make a foreign exchange transactions between a plan client and a party in interest that is a bank or broker (or affiliate of either), if:

- The transaction is a hedging transaction, that is, the transaction is made in connection with the purchase, holding or sale of securities or other assets;
- Its terms are no less favorable to the plan than those under comparable arm's length transactions between or involving unrelated parties;
- The exchange rate used does not deviate by more than three percent from the interbank bid and ask rates for comparable transactions as displayed by an independent exchange rate reporting service; and
- The bank or broker (or affiliate) neither has investment discretion nor provides investment advice with respect to the transaction.

Trades through Electronic Communication Networks. An adviser may cause a plan client to enter into a transaction in securities (or other property, such as futures contracts and currency, as may be determined by the DOL) with a party in interest that is executed through an electronic communication network, alternative trading

system, or execution system or trading venue that is subject to regulation and oversight by an applicable federal or foreign entity, under the following conditions:

- Either the transaction is effected through rules designed to match purchases and sales at the best price available through the system in accordance with applicable rules of the SEC or other relevant government authority, or neither the system nor the parties to the transaction take into account the identity of the parties;
- The price and compensation associated with the transaction are no more than in an arm's length transaction with an unrelated party;
- If the party in interest has an ownership interest in the system, the system has been authorized by the plan sponsor or other independent fiduciary; and
- A plan fiduciary is provided with at least thirty days' written or electronic notice of the first system transaction for the plan.

Changes to Bonding Rules. The Act amends ERISA's bonding rules to exempt a broker or dealer registered under section 15(b) of the Securities Exchange Act of 1934 from ERISA's bonding requirements, if the broker or dealer is subject to the fidelity bond requirements of a self-regulatory organization, within the meaning of the Securities Exchange Act, effective for plan years beginning after the date of enactment. A proposal to extend a similar bonding exemption to investment advisers registered under the Investment Advisers Act of 1940 was not enacted, however. The Act also increases the maximum bond amount from \$500,000 to \$1,000,000 for plans that hold employer securities, for plan years beginning after 2007.

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Advisers to funds in which ERISA plans invest should review and revise as necessary their Forms ADV, investment management agreements, offering circulars, partnership agreements, subscription agreements, offering questionnaires and related materials to conform them to the new "plan asset" rules. Advisers to accounts with ERISA Plans who desire to take advantage of the new prohibited transaction exemptions should develop policies, procedures and systems to address all conditions for the exemptions.

This letter only summarizes a few highlights of the 900-page Act that we think may be important to investment advisers. If you have any questions regarding the Act, please contact Doug Hammer, John Broadhurst, Geoff Haynes, Chris Rupright, Carolyn Reiser, Neil Koren, Joan Grant, Lyn Roberts, John Hunt, Anthony Caldwell, Jim Frolik or Christina Mickelson.

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