VOLUME 79 ◆ NUMBER 8

Employee Benefit Plan Review

Side Letters and Vesting

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Q How should an adviser of a mutual fund address an ERISA plan's request for a side letter?

A Side letters are a longstanding tool for investors in the hedge fund and private equity space to create more favorable terms, address concerns, and clarify or establish certain rights with respect to their investment. These rights and concerns can range from tax considerations, internal policies, and regulatory compliance to fund investor rights.

It is quite common for plans that are subject to the Employee Retirement Income Security Act of 1974 (ERISA) to negotiate side letters with respect to their private investments. ERISA plans commonly request side letters to ensure that the manager of the investment fund fully understands the requirements of ERISA and that the manager affirmatively represents that it is willing and able to comply with those requirements. Such side letters often request that the fund manager acknowledge its fiduciary obligations, if any, under ERISA; outline reporting requirements and investment limitations; and require the fund and/or manager to make representations and warranties that it will comply with ERISA. Side letters also commonly grant enhanced rights to information and reporting, most-favored-nations rights, and fee discounts.

While side letters are common in the hedge fund and private equity space, and often helpful to facilitate an investment, a side letter requested to facilitate an investment in a fund registered under the Investment Company Act of 1940 (1940 Act) is far less common and can be an unnecessary burden. This is because ERISA simply does not apply to the internal operations of registered investment companies.

ERISA itself expressly addresses investments in the shares of registered investment companies. ERISA Section 3(21)(B) provides that a plan's investment in a registered investment company "shall not by itself cause such investment company or such investment company's investment adviser or principal underwriter to be deemed to be a fiduciary or a party in interest as those terms are defined in [Title I of ERISA], except insofar as such investment company or its investment adviser or principal underwriter acts in connection with an employee benefit plan covering employees of the investment company, the investment adviser, or its principal underwriter."

In addition, ERISA Section 401(b)(1) provides that when an ERISA plan invests in a security issued by a registered investment company, "the assets of such plan shall be deemed to include such security but shall not, solely by reason of such investment, be deemed to include any assets of such investment company." Indeed, the legislative history evinces that Congress itself concluded that it did not need to apply ERISA's fiduciary rules to the operation of mutual funds in addition to the 1940 Act's regulatory scheme.

However, ERISA's exclusion for mutual funds is not absolute. ERISA does apply when a plan fiduciary decides to invest an ERISA plan's assets in a mutual fund. For example, an investment manager that invests plan assets in a mutual fund for which the manager is an investment adviser is a plan fiduciary as to that investment decision. Moreover, if an investment adviser is a plan fiduciary for a reason other than the investment in the securities of an investment company, the adviser remains a plan fiduciary.

Mutual funds are registered investment companies under the 1940 Act. As such, ERISA does not apply to the operation of the mutual fund. Consequently, a side letter in connection with an ERISA plan's investment in a mutual fund is unnecessary and may be burdensome.

Mutual fund investment advisers who receive a side letter from an ERISA plan should carefully consider the terms and conditions of such side letter. If an investment adviser chooses to enter into such side letter, it should do so only after carefully negotiating the letter and ensure that it is able to comply with the applicable terms and conditions. Investment advisers to mutual funds may also find it worthwhile to educate an ERISA plan on the applicability, functions, and differing regulatory and legal framework of mutual funds, which may address the concerns of the retirement plan.

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STOCK OPTIONS

Q Can we make changes to the vesting schedule of stock options?

A A "modification," which is treated as a grant of a new option under the U.S. Internal Revenue Code of 1986, as amended (the Tax Code), is any change in the terms of the option, plan or governing agreement that provides the option holder with additional benefits, regardless of whether they benefit from the change. This means that if an incentive stock option (ISO) is "in the money," it becomes a non-qualified stock option (NSO) or must be repriced at the fair market value at the time of the modification to maintain ISO status. In general, changes to vesting schedules are not considered "modifications" under the Tax Code. However, changes to the vesting schedule of an ISO may be considered a modification if the option is exercisable before fully vesting (so-called "early-exercise options").

A key tax implication for ISOs is that an optionee can only hold up to $100,000 worth of ISOs that first become exercisable in a given calendar year. Any options in excess of this limit are treated as NSOs. If ISOs are not immediately exercisable, the option first becomes exercisable when it vests. Thus, changes to the vesting schedule could impact the $100,000 limit.

As long as an NSO is exempt from Tax Code Section 409A, a company can change the vesting of the option. Because the chief purpose of a stock option is to give an optionee the ability to exercise the option whenever the optionee chooses (and when the option is in the money), it is extremely uncommon to subject a stock option to Tax Code Section 409A.

As with all changes to grants, amendments to the vesting schedule may require board approval and/or the consent of the grantee.

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