



Insights on...

CROSS-BORDER PENSION POOLING

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NEW INVESTMENT OPPORTUNITIES FOR THE U.S. ERISA PLANS OF MULTATIONALS

FOREWORD

As multinationals grow and expand their operations, managing the investments of a diverse group of pension plans in many countries becomes increasingly complex. Now, corporate governance over headquarter and subsidiary plan assets around the globe, including U.S. Employee Retirement Income Security Act (ERISA) assets, can be simplified. An April 2008 advisory opinion issued by the U.S. Department of Labor, at the request of Northern Trust, has cleared the way for U.S. pension plans to participate in cross-border pension pooling. Multinationals may consider using offshore tax-transparent investment structures to pool the assets of their global pension plans to enhance governance, achieve economies of scale and implement a consistent investment strategy based on "best of breed" fund manager selection. The aim of this paper is to illustrate the benefits of cross-border pooling. As a result, we hope you will gain a better understanding of this exciting innovation in pension management.

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EXECUTIVE SUMMARY

U.S. ERISA defined benefit retirement plan assets may now participate along with non-U.S. subsidiaries in cross-border pension pooling. To date, multinationals have been uncertain about investing their U.S. ERISA assets through an offshore, tax efficient fund vehicle. However, on April 9, 2008, the U.S. Department of Labor (DOL) issued an advisory opinion to Northern Trust that provides comfort to multinationals considering pooling assets from U.S. defined benefit plans and non-U.S. plans. Northern Trust, a pioneer of the cross-border pooling concept in 2001, has led the asset servicing industry in product innovation and design, and the issuing of this opinion underscores the ways in which Northern Trust continues to help shape the direction of the cross-border pooling business.

Multinationals may enjoy greater governance, expanded investment options and administrative ease. The global trend toward increasing cross-border investing can create significant overlaps in subsidiaries' asset allocation strategies, resulting in inefficiencies in oversight, management and cost. For example, 10 subsidiary plans may select 10 different equity investment managers around the world. However, a pooling solution enables a multinational to make an investment decision once, leveraging investment expertise and best-in-class equity managers for all of its plans. It also permits an expanded investment lineup for subsidiary plans that may lack the time or expertise to appoint fund managers in alternative investments, but who would benefit from potentially stronger performance in this asset class. In all, this promotes greater efficiency and control, arguably reduces risk and simplifies administration.

Multinationals and their U.S. ERISA pension plans must take several considerations into account prior to launching a pooling vehicle. To properly analyze the benefits and implications of pooling for your pension plans, a feasibility study, including a tax analysis, is an important first step. Once a decision is made to launch, additional steps include defining and resourcing an implementation plan, contemplating additional fiduciary responsibility, considering additional Internal Revenue Service (IRS) filing requirements, confirming the tax treatment of the pooling vehicle by each country of investment, and analyzing securities lending implications.

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Northern Trust

Choosing a global custodian with a flexible operating platform with the custody, fund accounting, administration and shareholder services infrastructure necessary to support fund structures with multiple countries of investor and multiple countries of investment, using multiple investment mandates managed by multiple fund managers, is highly advisable. One size does not fit all, so you will need an asset servicing partner who can adapt to your unique requirements for fund structure and mandates.

OPPORTUNITIES: POOLING OF U.S. ERISA ASSETS

Treasurers and pension investment directors of multinationals face a complex variety of national and international retirement and investment laws governing the subsidiaries' plans as well as those of headquarters. In this environment, improved fiduciary control and risk management techniques are being actively sought as these goals become corporate priorities. Cross-border asset pooling, which aggregates assets from investors located in more than one country or tax jurisdiction, offers a practical tool to help meet governance goals and achieve efficiency.

Now, U.S. ERISA defined benefit retirement plan assets may be commingled into a cross-border pension pooling vehicle. On April 9, 2008, Northern Trust received an advisory opinion from the DOL clearing the way for U.S. pension plan participation. The advisory opinion gives comfort to ERISA plan sponsors that these plans may now invest in a tax-transparent fund structure. The DOL clarified that the use of pooled offshore vehicles to hold the assets of multinationals' U.S. and non-U.S. pension plans administered by Northern Trust in the manner described in Northern Trust's request would not violate certain ERISA requirements relating to the holding of currencies or securities offshore. It also provides clarity for investment advisory firms seeking to include U.S. ERISA assets in an offshore fund. This development is important since U.S. pension plans often comprise a significant share of a multinational's total pension assets worldwide and provide needed scale for pooling.

The DOL's favorable opinion was based on detailed information supplied by Northern Trust on our custody, fund accounting and administration solution for cross-border, tax-transparent pooling, for which a U.S. patent is pending.

TAX TRANSPARENCY: FOCUSING ON SUBSIDIARY PLANS' TAX STATUS

The principal advantage of a tax-transparent fund structure is that the tax authorities within the investment jurisdictions "look through" these vehicles to determine

withholding rates based on the tax status of the underlying investors. This is a major reason why such vehicles appeal to multinational firms with pension plans located in numerous countries. An objective of multinational pooling is that each plan should pay the same tax withholding rate when investing through the pooling vehicle that it would have paid if it had invested directly in the securities held in the vehicle (e.g. global equities). As the concept of cross-border pension pooling was developing, the Luxembourg *fonds commun de placement*, or FCP, showed promise as a tax-transparent vehicle. In May 2003, the Irish government, eager to compete for cross-border assets, established the common contractual fund, or CCF, to support cross-border pension pooling. More recently, the Holland Financial Center has been promoting the Dutch *fonds voor gemene rekening*, or FGR (literally meaning, fund for joint account), which has emerged as an alternative fund structure to the FCP and CCF.

BENEFITS: ENHANCED GOVERNANCE, GREATER CONTROL, HIGHER POTENTIAL RETURNS

Many multinationals, particularly U.S.-based firms, have been watching developments related to U.S. ERISA plan participation in pooling closely. A variety of benefits related to pension plan governance and economies of scale may now be gained, including:

- **Greater governance over pension plan investments**, allowing plan sponsors increased opportunity to track, monitor and measure performance of the assets as well as to implement a consistent strategy that is shared among country plans.
- **More effective operational control**, reducing administrative and monitoring burdens on local pension plan managers.
- **Broader, more efficient selection of best-in-class investment managers worldwide** with potentially enhanced returns through the use of boutique firms and other specialists. A centralized process of manager selection or de-selection within an investment mandate is also facilitated using a pooled structure. The Investment Management Association in the United Kingdom has reported that "by pooling assets from subsidiary pension plans across the globe, a multi-national can give all plans access to best-in-class managers and specialized investment mandates, more effectively control investment risk, simplify administration and gain economies of scale."*

- **Reduced risk** through increased asset diversification, including the use of managers with complementary styles, or investing in alternative asset classes, such as private equity or hedge funds.
- **Diminished workload** for local administrators and decision makers.

As Mercer Investment Consulting notes, “By combining assets within a single pool and investment mandate, investors can achieve greater scale and purchasing power compared with maintaining many smaller mandates with separate benchmarks.”**

CONSIDERATIONS: WHAT EVERY MULTINATIONAL SHOULD KNOW ABOUT LAUNCHING A NEW VEHICLE

Cross-border pension pooling requires a measure of attention to achieve smooth implementation. This begins with the asset servicing firm. It is vital that they have the experience and skill to provide the custody and fund accounting and related services needed to support the fund structure and investment program the multinational may establish to maximize efficiency and performance gains, and that they can adapt to future changes in investment strategy. In addition, it is crucial to engage local pension management and local trustee bodies early on to foster collaboration and speed of implementation. Likewise, the support of senior management at company headquarters is critical. The time required to implement a comprehensive pooling structure depends on the scope of the project. Working with an asset servicing firm can provide efficiencies for pension managers at both corporate headquarters and subsidiary country plans.

A multinational, in conjunction with its legal and tax experts, custodian and fund administrator, must take a number of steps to launch a pooling vehicle, including, among other things:

- Agreeing on the launch date and initial investors
- Completing legal documentation to establish the vehicle
- Completing legal agreements between multiple parties
- Obtaining tax rulings for certain investors
- Obtaining tax rulings from certain countries of investment
- Deciding on the type of transition – cash or in specie

PIONEERING THE CONCEPT AND PRODUCT DEVELOPMENT

- **2002:** Northern Trust implemented cross-border pension pooling for two multinational plan sponsors.
- **2005:** Working with a multinational, client-led consortium, including Goldman Sachs Asset Management and Mercer Investment Consulting, Northern Trust helped create the first two fully tax-transparent, cross-border pension pooling vehicles.
- **2006:** Northern Trust's pooling platform earned the “Best Operations Innovation” award from *Operations Management*, a leading industry publication.
- **2007:** Northern Trust became the first custodian to secure reduced withholding tax rates for investors holding Italian equities through a client's tax-transparent pooling vehicle.
- **2008:** U.S. Department of Labor delivered its advisory opinion clearing the way for U.S. ERISA plans to participate in cross-border pooling.

Administrators will also have to take into account several scenarios:

- **If a transition manager is used**, the transition may need to be completed outside the vehicle; the time to complete the transition will need to be included.
- **If multiple investors are required**, all with the same launch date, additional time may be required to coordinate and complete the conversion.
- **If local regulatory/tax reporting is requested**, the global custodian and fund administrator will need to assess if this can be supported and revert with details of capabilities – whether additional time may be required to complete the conversion or an alternative approach is required.

Establishing a cross-border, pension-pooling vehicle that includes U.S. ERISA plan investors also requires, among other considerations:

Increased fiduciary responsibility. Assets of the sub-funds, including investments by a U.S. ERISA plan, are likely considered ERISA assets. U.S. plan trustees, investment managers, and the multinational's investment committees will each need to consider who will be responsible for making investment decisions for ERISA subfunds and any additional fiduciary responsibilities required.

THE IMPORTANCE OF GUIDANCE FROM THE DEPARTMENT OF LABOR

Cross-border pension pooling creates innovative structures to the advantage of multinationals. Because management of a U.S. ERISA plan can have a major impact on a multinational's pension investment strategies, treasurers of multinationals and ERISA plan trustees should be pleased with the DOL advisory opinion and the benefits to be derived from moving forward with pension pooling.

The DOL advisory opinion lays out a set of specific guidelines that multinationals and their custodians and investment managers are required to follow. It is advised that multinationals seek expert advice to successfully operate within the framework of the opinion.

Additional IRS tax filings. The success of cross-border pooling depends on the tax transparency of the pooling vehicle. Funds with ERISA assets should file elections with the IRS to be classified as partnerships. As foreign partnerships, funds with any U.S. investors must file U.S. tax returns and provide Schedules K-1 to its U.S. investors. U.S. investors should also consider possible application of the requirement to file information returns to report transfers of securities to an offshore pooling vehicle. The identity of each U.S. investor must be disclosed to the U.S. federal government.

Securities lending implications. Pension plans can enhance revenue by lending underlying securities in the plan, and investing in a cross-border, tax-transparent fund is no exception. In a pooling vehicle, securities lending is performed at the subfund level. However, different borrower restrictions and collateral requirements may apply at the subfund level due to the underlying investors in the subfund. DOL notice PTE 2006-16 expands the permitted borrowers and permitted collateral for ERISA investors. However, due

diligence must be performed prior to the launch of a subfund to determine the impact of U.S. rules on other investors.

Regulatory reporting. Once ERISA plans invest in a subfund, U.S. regulatory reporting should be filed on behalf of the subfund. The management company or parties responsible for the activities of the pooling vehicle must ensure the appropriate filing is completed. Working with a custodian and fund administrator with the relevant experience and capabilities is critical.

Selection of a pooling vehicle's custodian and fund administrator for the pooling vehicle is an important decision. The chosen asset servicing firm can add the greatest value by offering an operating platform able to record detailed information relating to income, capital gains and withholding tax at the investor level. This operational and technical capability supports the entire pooling structure and enables investors with different tax rates to pool assets, and helps multinationals meet the demands of a variety of local tax and regulatory agencies. In addition, an important level of comfort can be found from working with a global custodian that already has developed the capability to support pooling solutions for ERISA plans.

CONCLUSION: MOMENTUM CONTINUES TO BUILD

With greater efficiencies, enhanced returns and a desired balance between centralization and local control, cross-border pooling programs are attracting increased attention from multinationals.

Treasurers of multinationals and U.S. ERISA plan trustees who investigate cross-border pension pooling and secure expert guidance will be well-positioned to take advantage of these opportunities.

*www.investmentuk.org, 25 July 2005

** Mercer Investment Consulting, "Cross-border asset pooling," March 2006

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