

## Plan Asset Rule Changes Their Relevance for Private Investment Funds

**A** LITTLE-NOTICED SECTION OF THE PENSION PROTECTION ACT OF 2006 affects investments by employee benefit plans into private-equity funds and other investment vehicles. Funds that have benefit plans as investors no longer must aggregate government pension funds and foreign funds with the Employment Retirement Income Security Act of 1974 (ERISA) plan funds when applying the 25 percent “significant participation” limit. This means investments from government and foreign pension funds can be accepted without the risk that ERISA’s prohibited transaction and fiduciary rules would apply to the investment fund’s management of its assets. To take advantage of this change, an amendment may need to be made to the operating agreement or other governing document of the investment fund.

### The Rule Change

Pension plans regulated by ERISA are a major source of capital for private-equity funds and other pooled investment vehicles. If the amount of investment by “benefit plan investors” exceeds certain thresholds, though, all of the fund’s underlying assets can be deemed “plan assets.” If the fund’s assets are considered “plan assets,” then the law requires the fund’s managers to manage in a way that avoids “prohibited transactions” and complies with ERISA’s fiduciary standard of conduct.

There are several ways to avoid this result. One is to satisfy the criteria for being a venture capital operating company (VCOC) or, for funds that invest in real estate, the criteria for being a real estate operating company (REOC). Another way is to limit the percentage of each class of investment in the fund that can be held by benefit plan investors to 25 percent. This 25 percent limit is sometimes referred to as the “significant participation” test. A fund designed to meet this test throughout its life typically authorizes and requires withdrawals and transfers of interests in the fund so that the benefit plan investors’ shares stay below the 25 percent limit. Under 1986 Department of Labor (DOL) regulations, the definition of benefit plan investor for these purposes included both plans that are covered by ERISA and various non-ERISA plans, such as government and foreign pension plans.

Congress has now changed this definition by legislating a statutory definition of “benefit plan investor.” As revised, the only types of plans that are included in this definition, and hence in the 25 percent significant participation test, are plans that are subject to either Part 4 of ERISA (defined benefit plans) or Section 4975 of the Internal Revenue Code (qualified pension and welfare plans of U.S. employers).

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### Change Isn’t Necessarily Automatic

For those investment funds that previously avoided being the holders of “plan assets” by limiting benefit plan investors to 25 percent of any class, there is now an opportunity to apply the new definition and take in funds from government and foreign pension funds without applying those amounts against the 25 percent limit. In some cases, though, the organizational documents may have created contractual obligations based on the old definitions. The documents may need to be modified to use the new statutory definitions (or refer to them instead of to the old regulations) before the non-ERISA plans can be excluded from the 25 percent calculation.

Further, disclosure documents may have led current investors to expect the degree of concentration of benefit plan investors, defined in the old way. Managers considering a change in how these rules are applied to an existing fund should consider whether any existing investors could legitimately claim to be damaged by such a change in policy. The legal documents might require modification.

Many investment funds previously avoided the “plan assets” problem by qualifying as VCOCs or REOCs, standards that require regular testing for satisfaction of quantitative measures of investments that include substantial management rights. With the change in the law, these funds may in some cases find it easier to switch to the 25 percent significant participation test, which looks at the composition of the investors in the fund, rather than the portfolio investments of the fund. If the constituent documents of the fund afford the managers a choice of relying on either the VCOC or REOC exemption or the significant participation test, this change might be made without amending the documents. If the constituent documents don’t afford this flexibility, or if the significant participation test refers to the old regulations, then an amendment might be needed before the manager can change which exemption the fund uses.

### Detailed Explanation

*Why does it matter?* With certain exceptions, the DOL regulations (the “regulations”) provide that when an employee benefit plan acquires an equity interest in a fund, the plan’s assets will include both the plan’s equity interest in the fund and an undivided interest in each of the fund’s portfolio assets. The portfolio assets become “plan assets” and subject to the fiduciary responsibility and prohibited transaction rules of the regulations (as well as the applicable rules found in Sec. 4975 of the Internal Revenue Code). This is known as the “look-through” rule of ERISA’s plan assets regulations.

Sec. 3(21) of ERISA defines “fiduciary” as anyone who exercises discretionary control or authority over management of a plan or plan assets. It follows that if the portfolio assets of a fund are considered to be the assets of the pension plan that invests in the fund (i.e., “plan assets”), then the fund’s manager will be considered a fiduciary and be subject to ERISA’s fiduciary rules.

The fiduciary rules are contained in Sec. 404(a)(1) of ERISA. These rules impose a duty of care, diligence, and loyalty on fiduciaries, as well as a duty to diversify the investments of the plan to reduce the risk of loss. Further, Secs. 406(a)(1)(A) through (E) prohibit a fiduciary from knowingly or negligently engaging in certain transactions with a “party in interest” (transactions that are referred to as “prohibited transactions”). Under Sec. 3(14) of ERISA, a “party in interest” is defined to include, among others, (1) any employer with employees participating in the plan; (2) any participant in the plan; (3) any other fiduciary of the plan; (4) any person providing services to the plan; (5) any 10 percent shareholder of the employer or a service provider; and (6) any entity of which 50 percent or more is owned by (1) through (5).

There are also prohibitions against fiduciaries engaging in acts of self-dealing. Sec. 406(b) of ERISA forbids fiduciaries from (1) dealing with plan assets in their own interest or for their own account; (2) representing a party whose interests

are adverse to the plan or the plan’s participants; or (3) receiving remuneration for their own account from another party in a transaction involving plan assets.

Thus, if the portfolio assets of the fund are deemed plan assets, then the fund’s manager will be constrained by the foregoing duties and prohibitions as a fiduciary of the ERISA plan that invested in the fund. As a deemed fiduciary, the manager would be required to discharge his duties solely in the best interests of the plan (as opposed to the interests of all other investors).

In addition, ERISA imposes special reporting and information disclosure requirements regarding the entity whose underlying assets are considered plan assets. The application of these rules can constrain a fund manager in the exercise of business judgment. The manager is bound to make decisions regarding the investment or disposition of the fund’s assets based solely on the fiduciary requirements of Sec. 404, even if those interests aren’t aligned with those of the fund itself or its other investors.

Additionally, the fund would be prevented from entering into any transactions that are prohibited because the manager is now considered to be a plan fiduciary. The remedies for violation of these rules could include disgorgement of financial gains, prohibition against accepting pension plan investments in the future, and civil penalties. Collectively, these strictures could serve to impede normal private investment fund operations and potentially prevent significant capital from being invested in the fund. It’s essential, therefore, to determine whether the underlying assets of any pooled investment vehicle will be treated as plan assets.

*What can be done about it?* There are four basic exceptions to the look-through rule that, if satisfied, will prevent a fund’s portfolio assets from being considered plan assets. These are: (1) non-equity investments; (2) investments that are publicly traded securities; (3) investments in which there is no “significant” (defined as less than 25 percent) participation by

benefit plan investors; and (4) investments in operating companies (including VCOCs and REOCs).

**Non-equity investments.** The fund’s portfolio assets are considered plan assets only if an employee benefit plan owns an equity interest in the fund. This term is defined as “any interest other than an instrument that is treated as indebtedness under applicable local law and which has no substantial equity features.”

**Investments that are publicly traded securities.** The fund’s portfolio assets won’t be deemed plan assets if the fund is a “publicly offered security.” This is satisfied if (1) offerings of interests in the fund are registered under the Securities Act of 1933 (the “Securities Act”) when purchased and subsequently registered under the Security Exchange Act of 1934 (the “Exchange Act”) within 120 days following the end of the fiscal year; (2) the securities are “widely held” by 100 or more investors independent of the issuer and of one another; and (3) the securities of the fund are “freely transferable,” which is a matter of facts and circumstances. If the security is part of an offering in which the minimum investment is \$10,000 or less, there is a presumption of free transferability.

**The significant participation test.** If a benefit plan’s equity participation in the fund isn’t “significant,” the fund’s portfolio assets won’t be deemed plan assets. Equity participation isn’t significant if benefit plan investors hold less than 25 percent of any class of equity interests. Until enactment of the Pension Protection Act of 2006, “benefit plan investors” included not only pension and welfare benefit plans that are subject to ERISA but also individual retirement accounts, Keogh plans covering only self-employed individuals, government plans, church plans, and entities whose assets are considered plan assets. After enactment of the Pension Protection Act, the only plans that are counted as benefit plan investors are those plans that are subject to either Part 4 of ERISA (defined benefit plans) or Sec. 4975 of the Internal Revenue Code (qualified pension and welfare plans of U.S. employers).

**Operating companies, including VCOCs.** Generally, an operating company is an entity that is primarily engaged, directly or through a majority-owned subsidiary, in the production or sale of a product or service other than the investment of capital. This distinguishes between companies that carry on an active trade or business and those that fundamentally serve as conduits for the provision of investment management services. In addition to the general operating company exception, a fund can be classified as either a VCOC or an REOC to avoid plan asset regulation.

The VCOC exception is limited to companies that have demonstrated a “substantial, ongoing commitment to the venture capital business.” This is defined by detailed periodic measurements of the portion of the fund’s portfolio that is deployed into companies in which the fund has and exercises significant management.


Here’s a short summary of how those measurements must be made. (Different measurements of similar complexity apply to REOCs.) A fund will be deemed a VCOC if (1) at some time during the “annual valuation period” at least 50 percent of its assets (valued at cost) are invested in “venture capital investments,” and (2) in each year, measured from the end of each annual valuation period, the fund has and exercises “management rights” over at least one of its portfolio companies.

The regulations define a “venture capital investment” as “an investment in an operating company (other than a VCOC) as to which the investor has or obtains management rights.” It follows that in order for a fund to qualify as a VCOC, the fund’s manager must take care that at least 50 percent of the fund’s assets (valued at cost) are invested in portfolio companies in which the fund has management rights.



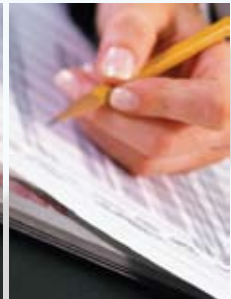
Additional rules make it possible for a

fund to manage its investments through a portfolio company’s normal life cycle without jeopardizing its status as a VCOC. When a venture capital investment is taken public, for example, the fund’s contractual management rights can be lost without destroying the VCOC status of the fund. That’s because “derivative instruments” can also be counted toward the 50 percent venture capital investment requirement. A derivative instrument is a venture capital investment “as to which the investor’s management rights have ceased in connection with a public offering of securities” or one that was exchanged for certain venture capital investments in connection with a public offering.

These investments will lose their status as derivative instruments (and thus no longer count toward the 50 percent requirement) either (1) when they’re sold or distributed to the fund’s investors; or (2) on the later of 10 years from the date of the acquisition



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of the underlying investment or 30 months from the date on which the investment became a derivative instrument.

As noted above, the fund must have management rights in the portfolio companies that it counts toward the 50 percent requirement. The term “management rights” is defined as “contractual rights directly between the investor and an operating company to substantially participate in, or substantially influence the conduct of, the management of the operating company.” The fund need not exercise these rights in all portfolio companies in every year, but the fund must exercise its management rights in at least one portfolio company during each year.

The regulations don’t explicitly state which “contractual rights” would constitute “management rights” for the purposes of this exception. While this is ultimately a question of facts and circumstances, the preamble to the regulations provides some

specific instances of sufficient contractual rights. For example, if the fund has the right to appoint a board member, or if a representative of the fund serves on the board of the portfolio company, this requirement will be satisfied.

Further, the right to examine the books and records of a non-public company also indicates management rights. The regulations don’t state exactly which contract must contain these rights. Presumably, it may not be sufficient if these rights exist merely in fact (as where a fund representative is elected to the board) by operation of law (such as by virtue of the rights inherent in the securities purchased by the fund).

**Implications**

As a practical matter, private investment funds seeking exemption from plan assets regulation either restrict investments by benefit plan investors to less than 25 per-

cent or qualify as a VCOC or REOC. It’s unlikely that a fund will be able to attract capital from plans if the fund’s manager isn’t able to provide representations that the fund will maintain one (or both) of these exemptions at all times.

In the past, many funds chose to rely on the VCOC or REOC exemption, necessitating periodic evaluation of the portfolio companies and the exercise of management rights to ensure continued exemption. With the change in the composition of the “benefit plan investors” group, to exclude plans that aren’t covered by Part 4 of ERISA or Sec. 4975 of the code, fund managers may rethink which of the exemptions will be easiest to use.

For existing funds, use of the significant participation test may require revision of the operative documents. For new funds, the operative documents, if carefully drafted, can incorporate this exemption from the outset.

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