The US Private Equity Fund Compliance Guide

How to register and maintain an active and effective compliance program under the Investment Advisers Act of 1940

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Background

Although there has been some headway in recent years in structuring hybrid private equity funds that can hold plan assets, ERISA (the Employee Retirement Income Security Act of 1974) compliance for private equity funds generally consists of avoiding the application of ERISA to the fund's assets and to the activities of its investment manager. Generally, private equity funds cannot be managed in accordance with ERISA's restrictions. For example, the fee structure of a typical private equity fund does not fit within the US Department of Labor (DOL)'s approved methods for charging performance fees, the purchase of any warehoused investments would raise ERISA prohibited transaction issues, and the payment of certain expenses and the receipt of board of directors and other fees would be problematic under ERISA's strict self-dealing and reporting regime.

Pension plans subject to Title I of ERISA (for example, US corporate and union plans) as well as pension plans not subject to Title I of ERISA (for example, plans sponsored by governments and non-US entities) are a significant part of private equity funds' investor base. In 1986, the DOL issued the 'plan assets regulation' that defined the circumstances when the investment manager of a vehicle in which plans invest should be subject to the same rules as investment managers who act directly for employee benefit plans subject to ERISA. Generally, the plan assets regulation provides that when an employee benefit plan owns an equity interest in an entity that is not publicly traded nor engaged in the production of goods or services (other than the investment of capital), the assets of the entity will be deemed to be held directly by each plan investor, unless benefit plan investors own an insignificant percentage of the entity's equity interests.

In defining when a company was an operating company because it engaged in the production of goods or services other than the investment of capital, the DOL defined two specific types of operating companies: venture capital operating companies (VCOCs) and real estate operating companies (REOCs). The DOL found that these types of companies shared the attributes of both investment vehicles and operating companies and listed the specific requirements that a private equity or real estate fund needed to meet to be a VCOC or REOC and thereby avoid the 'look through' imposed by the plan assets regulation.

Due to the significant allocations by governmental plans to private equity, for 20 years VCOC compliance was the only option a private equity fund had to avoid the application of ERISA. When Congress passed the Pension Protection Act of 2006 (the 'PPA'), it added Section 3(42) to ERISA which provided that governmental plans, church plans and non-US plans would no longer be considered 'benefit plan investors' and therefore no longer count in the numerator of an investment vehicle's significant participation test. Because governmental and non-US plans typically were the largest plan investors in private equity funds, the PPA permitted many funds to rely on the significant participation exception to avoid the look-though imposed by the plan assets regulation.

Most private equity funds launched since the PPA was enacted provide that they will comply with either the significant participation or the VCOC exception to avoid the application of ERISA to the fund. Typically, an election specifying which exception the private equity fund will rely upon is made at the funds' final closing and at that point disclosed to its investors.

The VCOC exception

The VCOC test is exceptionally technical. Therefore, private equity funds that are relying on the VCOC exception to ERISA's 'look-through' rule typically engage legal counsel to provide an ERISA opinion to the plan investors holding that upon the entity's first long-term investment, the fund should qualify as a VCOC. Annually thereafter, the investment manager of the private equity fund typically provides a certification to the fund's plan investors that the fund satisfied the VCOC conditions during its 'annual valuation period.'

In general, to qualify as a VCOC two tests must be satisfied:

- An 'asset test' which tests the amount of a VCOC's investments in 'qualifying investments' at specified time periods (known as 'valuation periods'); or
- A 'management test' which tests the resources devoted by a VCOC to the management of its portfolio companies on an ongoing basis.

In addition, there are special rules that apply during the distribution period which permit a VCOC to retain its status while liquidating and distributing its assets to its investors.

The assets test

The assets test requires that on the date of its first long-term investment and thereafter on one day during each annual valuation period, at least 50 percent of the VCOC's assets (other than short-term investments pending long-term commitment or distribution to investors), valued at cost, be invested in qualifying investments. Qualifying investments are either 'venture capital investments' or 'derivative investments.'

A venture capital investment is an investment in an operating company, other than a VCOC, with respect to which the investor has or obtains management rights. An operating company is an entity that is engaged in the production or sale of goods or services other than the investment of capital and includes REOCs. 'Management rights' are contractual rights directly between the VCOC and an operating company that allow the VCOC 'to substantially participate in, or substantially influence the conduct of, the management of the operating company.'

'Derivative investments' are venture capital investments where the management rights have been extinguished in a corporate transaction. Derivative investments are required to lose their venture capital investment status through a public offering, merger or reorganization of the portfolio company. Derivative investments retain their qualified status until the later of ten years from the acquisition of the original venture capital investment, or two and a half years from the investment becoming a derivative investment.

The management test

The management test is an ongoing test applied during the period that begins on the date of the first investment and ends on the date of the first 'annual valuation period' for a new VCOC and, thereafter, during the 12-month period following each annual valuation period. During such period, the VCOC must in the ordinary course of its business exercise management rights with respect to one or more portfolio companies. Management rights are the same rights described above in the assets test (that is, to substantially participate in the management of a portfolio company or to substantial influence the management of a portfolio company). The DOL has issued an advisory opinion that lists certain rights, in addition to a seat on the board of directors, as management rights. The DOL opinion describes a collection of rights that in total would amount to management rights for the purposes of the VCOC test. These rights were documented in a contract between the VCOC and the portfolio company and required that the VCOC be provided with periodic financial reports of the portfolio company and any other documents, reports, financial data and information as may reasonably be requested. Additionally, the portfolio company was obligated to allow any authorized representatives designated by the VCOC to visit and inspect any of the properties of the portfolio company, including its books of account, and to discuss its and their affairs, finances and accounts with its and their officers, all at such times as the VCOC may reasonably request. The preamble to the plan assets regulation made it clear that management rights must not be exercised on a sporadic basis and that 'substantial resources' must be devoted to management efforts.

Significant participation or the 25 percent test

The plan assets regulation provides that an entity and its investment manager will be subject to ERISA if the entity has significant participation by benefit plan investors. Significant participation is deemed to occur when 25 percent or more of the value of any class of equity interest in the entity is held by benefit plan investors, excluding from this calculation any non-benefit plan investor interests held by a person who has direct or indirect discretionary authority or control, or who provides investment advice for a fee, with respect to the entity's assets, or any affiliate of any such person (the '25 percent test').

Benefit plan investors

The 25 percent test must be computed upon each contribution to or redemption from the fund. However, because most private equity funds are closed-end funds, this is not an administrative burden. Since the passage of the PPA, a benefit plan investor is any of the following:

- Any 'employee benefit plan' subject to the fiduciary responsibility provisions of Part 4 of Title I of ERISA (for example, US corporate, union and Taft-Hartley plans). (A benefit plan of a non-US company is not a 'benefit plan investor.')
- Any 'plan' that is subject to the prohibited transaction rules of Section 4975 of the Internal Revenue Code (for example, individual retirement accounts (IRAs) and Keogh plans).

- Any entity whose underlying assets include plan assets by reason of a plan's investment in the entity (for example, fund of funds and certain bank or insurance company accounts).

Classes of equity interests

Under the 25 percent test, each class of equity interest must be tested separately. For example, if a private equity fund issues class A and class B interests (for example, because the class B interests do not participate in a certain type of investment), the 25 percent test must be conducted for each class. If benefit plan investors hold a significant percentage of shares of either class, the fund would be deemed to hold plan assets.

Affiliated investments

The 25 percent test provides that the value of any non-benefit plan investor equity interests in the fund held by a person who has direct or indirect discretionary authority or control, or who provides investment advice for a fee, with respect to the private equity fund's assets, or any affiliate of such person, shall not be included in the denominator when calculating the 25 percent test. For example, if a principal or an employee of the investment manager invests his own personal money in the fund, that investment is excluded from the 25 percent test's denominator. In contrast, if a principal or employee directs his IRA custodian to invest his IRA in the fund, the investment is made by a benefit plan investor (BPI) and, therefore, is included in both the numerator and the denominator.

The following fraction illustrates the application of the 25 percent test:

$$\frac{\text{Total value of a class of shares held by BPIs}}{\begin{array}{c}\text{Total value of a class shares less the value of shares held by} \\ \text{the adviser(s) and its affiliates and employees (other than through BPIs)}\end{array}}$$

Proportionality

The PPA also changed the way the 25 percent test applies to investors that are entities whose underlying assets are also plan assets. Under the PPA, a benefit plan investor that is an entity shall be considered to hold 'plan assets' 'only to the extent' of the percentage of its equity interests held by benefit plan investors. This means that if a fund of funds investor in a private equity fund is a benefit plan investor (because of its own investor base), only the portion of such investment that is 'plan assets' will be included in the investment fund's numerator as benefit plan investor money. However, the entire amount of the investment would be included in the denominator. Similarly, if an insurance company general account is investing 'plan assets,' only the portion of such investment that represents 'plan assets' will be included in the investment fund's numerator. This 'proportionality rule,' however, does not extend to investments from group trusts, common or collective trust funds of banks and insurance company separate accounts that invest 'plan assets' and, therefore, the entire investments from those entities are included in the investment fund's numerator.

Implementation

The typical private equity fund launching after 2006 was enacted provided that upon the final closing the investment manager would decide whether to rely on the significant participation or the VCOC exception. However, because the two exceptions are tested at different times, complying with both tests during the periods between the first and final closing can be challenging. The 25 percent test is conducted at each closing, and if total commitments by benefit plan investors equal or exceed 25 percent of total commitments, the fund would fail the 25 percent test until the next closing when the test would be conducted again. On the other hand, the VCOC test is conducted on the fund's first long-term investment and the annually during the subsequent annual valuation periods. However, if the fund's first investment is not a qualifying venture capital investment, the fund can never be a VCOC. Therefore, funds that are waiting to see whether at the final closing they will be able to meet the 25 percent test must make sure the fund's first investment is a qualifying venture capital investment and that the fund meets the VCOC exception. This is true even if the at the time of the first investment the fund is under the 25 percent limit.

Pros and cons of each exception

Before 2009, a private equity fund that could rely on the significant participation exception typically did. Complying with the VCOC exception is burdensome, whereas complying with the 25 percent test for a fund with no, or extremely limited, redemptions and one class of equity interests issued to investors is straightforward. However, the DOL's new Form 5500 Schedule C reporting rules adopted in 2009 only apply to funds that rely on the significant participation exception and not to funds that rely on the VCOC exception.

Schedule C to the Form 5500

For plan years beginning after 2009, the DOL revised the Form 5500, the informational report which every employee benefit plan is required to file annually with the federal government. These changes require disclosures of the compensation paid to plan service providers as well as to the service providers of investment funds in which a plan has invested. The revised Schedule C requires reporting 'indirect compensation' paid to service providers, such as investment managers, by mutual funds and private investment funds. This requirement applies even though the mutual fund or private investment fund is not itself subject to ERISA. Under the revised Form 5500, if the investment manager of an investment fund (for this purpose an 'investment fund' includes mutual funds, private investment funds, whether or not subject to ERISA, and separately managed accounts, but excludes private equity funds, that is, a VCOC or REOC) receives only 'eligible indirect compensation' and provides the plan administrator with certain information, then the plan can utilize an alternative reporting method and merely list the name and EIN number of the investment manager on Schedule C.

Compensation paid from the investment fund to service providers that consists of asset-based management fees, performance fees or allocations, finder's fees received due to a plan's investment in an investment fund and soft dollars generated from trades by an investment fund with plan investors are all 'eligible indirect compensation.' Brokerage commissions associated with execution costs and other ordinary operating expenses of an investment fund are not reportable on Schedule C. However, if an investment manager of an investment fund receives compensation directly from a plan or receives indirect compensation that is not 'eligible,' for example, gifts or entertainment that is more than *de minimis* or fees from third parties in connection with a fund investment, then the alternative reporting method will not be available and the investment manager will need to respond to its ERISA clients' individual information requests. The detailed information provided with respect to 'ineligible indirect compensation' includes the of the service provider, the type of services and the amount of compensation paid; this information is included on the investing plan's Schedule C which a public document.

VCOC exception

Pros

- No limit on the amount of benefit plan investors that may be accepted into the fund.
- No issue if a benefit plan investor must redeem from the fund or fails to honor a capital call.
- No need to provide Schedule C fee disclosures to ERISA plan investors.

Cons

- *Limits on fund investments:* at least 50 percent of the fund's investment must have direct management rights.
- *Constraints on distributions:* the VCOC exception defines a 'distribution period' during which VCOC status continues even if the asset and management tests are failed, but the distribution period ends in ten years, or earlier if the VCOC makes a 'new portfolio investment.'
- *Expenditure of resources:* significant resources of the investment manager must be devoted to management activities.
- *Costs:* the VCOC opinion and the legal fees associated with producing the annual certificate can be costly, as are the administrative expenses for organizing and retaining the documentation (board minutes, financial reports and comments, as well as travel and hotel receipts) to demonstrate compliance with the management test.

Significant participation exception

Pros

- No limitation of the fund's investments or the timing of its distributions.
- No need for legal opinions; annual certificates are common.
- Little administrative burden or expense to maintain and demonstrate compliance with the 25 percent test.

Cons

- Form 5500 requires certain employee benefit plans to disclose compensation paid to their service providers as well as to the service providers of investment funds in which the plans have invested. Schedule C now requires reporting 'indirect compensation' paid to service providers, such as investment managers of private investment funds in which the plan has invested.
  - Schedule C defines two types of indirect compensation: 'eligible indirect compensation' and 'ineligible indirect compensation.'
- Eligible indirect compensation is substantially easier to report on Schedule C and includes compensation paid from the investment fund to service providers that consists

of asset-based management fees, performance fees or allocations, finder's fees received due to a plan's investment in an investment fund and soft dollars.

- Ineligible indirect compensation generally includes such items as non-monetary gifts, indirect compensation that is not related to the plan's investments, board of directors and other transaction related fees.
  - Most private equity funds will have some ineligible indirect compensation, which may require the following disclosures on the plan investor's Form 5500: the name of the private equity fund's investment manager; the service code(s) that describe the services provided; the amount of direct compensation received; the amount of ineligible indirect compensation received; the name and employer identification number of the source of indirect compensation; and a description of the indirect compensation, including any formula used to determine the service provider's eligibility for or the amount of the indirect compensation.
- Should a non-benefit plan investor fail to honor a capital call or be prevented from participating in a particular investment, the 25 percent threshold could be crossed and preventing or remedying that situation could be difficult and have adverse economic consequences to the investor and/or the private equity fund.

Avoiding PBGC liability

The Pension Benefit Guaranty Corporation (PBGC) is a governmental corporation, similar to the FDIC that provides mandatory insurance for defined-benefit pension plans. Upon involuntary termination, the PBGC takes over a plan's assets and administration and pays the retirees' guaranteed benefits. The PBGC pays the plan's benefits from the assets it assumes in the termination and from premiums it collects from all defined-benefit plans. Under Title IV of ERISA, the PBGC has a priority lien over all of the assets of any member in the control group (as defined below) of the employer sponsoring the terminated plan.

In December 2007, the PBGC released a September 26, 2007 appeals board decision holding a private equity fund was liable for the pension underfunding of one of the fund's portfolio companies. The fund was organized as a Delaware limited partnership (the 'Fund') and it owned 96 percent of one of its portfolio companies (the 'Company'). When the Company filed for bankruptcy, the PBGC terminated its underfunded pension plan and asserted that the Fund was liable for the Company's unfunded pension liabilities. The Fund appealed the PBGC's determination, arguing that the Fund, an unincorporated entity, was not engaged in a trade or business necessary to create ERISA controlled group liability because it was merely an investment vehicle with no employees, no involvement in its portfolio company's day-to-day operations and no income other than passive investment income.

The appeals board of the PBGC has held that a private equity fund and its portfolio companies were, based on their 80 percent common ownership, part of a controlled group and therefore jointly and severally liable for the funding deficiency in one of the Company's defined-benefit pension plan. Under ERISA, a control group is generally a group of trades or businesses in which the parent owns at least 80 percent of the total voting power of all classes of stock entitled to vote or at least 80 percent of the total value. The appeals board rejected the Company's argument that a private equity fund should not be included in the same control group as their portfolio companies because a fund does not carry on a 'trade or business' within the meaning of ERISA. The PBGC found that the Fund was a 'trade or business' and was a member of the same controlled group as its 80 percent owned Company and therefore, the Fund was required to use its assets to make a contribution to the pension plan of the Company.

Although a private equity fund does not typically own 80 percent or more of a portfolio investment, investment managers should consider the implications of the PBGC's position when structuring investments in a portfolio company that sponsors a defined-benefit pension plan. It may be possible to structure transactions in ways that reduce or eliminate the possibility that a private equity fund sponsor would be considered part of the same controlled group as its portfolio companies even if the fund is viewed as a 'trade or business.' For example, may private equity sponsors own interests through a series of partnerships including alternative investment vehicles and thus dilute the ownership of any one portfolio company entity to less than 80 percent. □

Compliance checks:

- A fund that is subject to ERISA will have significant limitations on investments and receipt of certain fees.
- The two tests to be able to avoid ERISA coverage are: (i) having fewer than 25 percent in dollar amount of benefit plan investors funds; or (ii) the fund meets certain operating requirements to be more like an operating company – venture capital operating company (VCOC) or real estate operating company (REOC).
- The fund typically determines which test it will meet at the time of the first closing.
- The 25 percent test should be checked at each capital contribution or redemption.

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