

New Pension Law Changes Plan Asset Rules: Good News for Private Equity Funds and Fund Managers

The Pension Protection Act of 2006 (the "Act") was passed by the House on July 28, 2006 and the Senate on August 3, 2006. The Act was presented to President Bush on August 14, 2006 for his signature, and he is expected to sign it on August 17, 2006. The Act makes sweeping changes to many areas of pension law, and a subsequent Alert will address those changes. This Alert focuses on two changes to the plan asset rules under the Employee Retirement Income Security Act of 1974 ("ERISA"), the impact of which is good news for private equity investment equity funds (including venture capital funds) and fund managers and advisers.

Plan asset rules

The plan asset rules are contained in a Department of Labor regulation that details when the assets of an ERISA plan making an equity investment in a non-publicly traded entity include not only that equity interest but also an undivided interest in the underlying assets of the entity.¹ Unless the entity qualifies as a venture capital operating company ("VCOC")² or a real estate operating company ("REOC")³, the assets of the entity are considered assets of the ERISA plan ("plan assets") if equity participation in the entity by benefit plan investors is "significant." The result of finding benefit plan investment to be "significant" is that persons with authority or control over the management or disposition of the entity's assets or providing investment advice for a fee with respect to such assets are considered fiduciaries of the investing

ERISA plans. As ERISA fiduciaries, they are subject to ERISA's various reporting, disclosure, fiduciary responsibility, and prohibited transaction rules.

"Significant" participation— before and after the Act

Equity participation by benefit plan investors is considered "significant" if, immediately after the most recent acquisition of any equity in the entity, 25% or more of the value of any class of equity interest in the entity (disregarding certain interests) is held by benefit plan investors (the "Significant Participation Test"). Before the Act, the term "benefit plan investor" was defined to include (1) employer-sponsored plans (including those exempt from ERISA, such as governmental plans and foreign plans), (2) other arrangements such as IRAs that are subject only to the prohibited transaction rules of the Internal Revenue Code (the "Code") and (3) any entity whose assets are plan assets by reason of a plan's investment in the entity.

The Act will change the definition of "benefit plan investor" by limiting it to (1) benefit plans subject to ERISA's fiduciary rules, (2) plans subject to the Code's prohibited transaction rules and (3) any entity whose assets include plan assets by reason of such a plan's investment in such entity. The revised definition excludes plans that are exempt from ERISA, primarily governmental and foreign plans, such that investment by those types of plans is no longer relevant when determining whether benefit plan investment equals 25% or more.

In addition, the Act clarifies that only the portion of the assets of a private fund (e.g., a feeder fund) that is attributable to investment by plans that are benefit plan investors under the Act is taken into account when applying the Significant Participation Test to participation by the private fund. Prior to this clarification, one (and probably the dominant) interpretation of the Significant Participation Test was that the entire investment by a private fund with significant benefit plan investment should be treated as made by a benefit plan investor regardless of the actual percentage of its equity held by benefit plans. For example, assume that a feeder fund has a single class of equity interests equal to \$200 million and ERISA plans hold \$70 million of those interests (i.e., 35% of the fund). Because benefit plan investment exceeds 25%, the assets of the feeder fund are considered "plan assets" under the Significant Participation Test. Prior to the Act's clarification, any investment by the feeder fund in another private fund likely would have been

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counted as 100% benefit plan investment for the downstream fund's own Significant Participation Test. Thus, if this feeder fund is the only benefit plan investor in a downstream fund in which it invests \$30 million and the downstream fund has total equity interests of \$100 million, the benefit plan investment in the downstream fund likely would have been calculated as 30% and the assets of the downstream fund would have been considered "plan assets" under the Significant Participation Test. However, the Act's clarification of this calculation results in finding that benefit plan investment in the downstream fund will only equal 10.5%⁴ such that the assets of the downstream fund will not be "plan assets."

Practical effect of the Act

While many private funds strive to qualify as either a VCOC or a REOC to escape the reach of the plan assets rules, not all are able to do so and thus must make use of the Significant Participation Test.⁵ There are a number of practical effects of the relaxation and clarification of the Significant Participation Test. First, investment by governmental and foreign plans is no longer subject to the Significant Participation Test such that investment by those plans no longer needs to be monitored (and perhaps limited) for purposes of the plan assets rules. Second, exclusion of governmental and foreign plans from the Significant Participation Test will result in increased capacity for investment by ERISA plans before benefit plan investment is considered significant. Third, the clarification as to how an investment by a feeder or other upstream fund with significant benefit plan participation is treated for purposes of a downstream fund's Significant Participation Test will reduce the number of downstream funds found to be holding plan assets based on a feeder fund's investment. Finally, the reduction in the likelihood of funds holding plan assets because of the Act's relaxation and clarification of the Significant Participation Test will mean that fewer managers and advisers will be considered ERISA fiduciaries.

These changes are effective for transactions occurring after the date of the enactment of the legislation, which is the date on which President Bush signs it into law. Given that the changes apply to "transactions" after the enactment date, it is not yet clear what effect they will have on funds with significant benefit plan investments (or on the plans investing therein) under the pre-Act rules on that date.

If you have questions about this *Alert*, please contact one of the attorneys listed at the beginning of this *Alert*. ■

Notes

¹ DOL Reg. §2510.3-101.

² The qualification requirements for a venture capital operating company are contained in DOL Reg. §2510.3-101(d).

³ The qualification requirements for a real estate operating company are contained in DOL Reg. §2510.3-101(e).

⁴ $[(\$70 \text{ million} \div \$200 \text{ million}) \times \$30 \text{ million}] \div \$100 \text{ million} = 10.5\%$

⁵ Even a fund qualifying as a VCOC or a REOC will use the Significant Participation Test as a back-up to these exemptions, where necessary.