



Apr 13, 2020

Categories:

[Blogs](#)

[Fiduciary Focus](#)

[Private Equity Industry](#)

[Blog](#)

Authors:

[Sarah N. Lowe](#)

Navigating the Plan Asset Rules: ERISA Plan Investment in Private Equity Funds | Fiduciary Focus Series

Pension funds subject to the Employee Retirement Income Security Act of 1974, (“ERISA”) serve as a significant source of institutional capital for the private equity market. As a result, many private equity funds seek ERISA investors. But ERISA plan investors are subject to a statutory and regulatory regime that imposes a very high standard of care (the “fiduciary standard of care”) and a number of prohibitions in connection with the investment of ERISA plan assets.

Depending on a fund’s structure and operations, the unwary private equity manager of a fund with ERISA plan investors can find itself an ERISA fiduciary, subject to many of the same stringent rules that apply to ERISA plans. Therefore, it is critical, private equity fund managers understand the plan asset rules, including how to be exempt from them, and the unique interests of ERISA plan investors.

Background

If an investment fund is deemed to have plan assets, the general partner or managing member of the fund will become an ERISA fiduciary to its ERISA plan investors and subject to the ERISA fiduciary standard of care.

Congress adopted ERISA’s fiduciary standard of care to safeguard the investment of retirement assets, and in doing so, made ERISA fiduciaries subject to the highest standard of care under the law. An ERISA fiduciary is anyone who has, or exercises discretion over the assets of an ERISA plan. An ERISA fiduciary must discharge its duties prudently, solely in the interests of plan participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries.

An ERISA fiduciary must also avoid direct or indirect plan transactions involving “parties in interest” and conflict of interest

transactions (referred to as “prohibited transactions”). The definition of “party in interest” under ERISA is far reaching, and the consolidation of the financial services industry has extended its reach to entities without any apparent relationship to a plan. Fiduciaries can incur personal liability for fiduciary breaches, and the penalties for prohibited transactions can be extreme, ranging from excise taxes and restoring plan losses to disgorging profits and undoing transactions.

Should an investment fund be found to have plan assets, any transaction with the fund may be deemed a transaction with each ERISA plan investor, which in turn, creates the risk that any transaction entered into by the fund in the ordinary course of its business could be a prohibited transaction.

Neither ERISA nor the Code explicitly defines the term “plan assets” as applied to entities in which an ERISA plan invests. However, the Department of Labor (“Department”) adopted regulation 29 C.F.R. Section 2510.3-101, as amended by ERISA Section 3(42), which addresses investments by ERISA plans (“Plan Asset Regulations”). In the preamble to the Plan Asset Regulations, the Department emphasized that Congress could not have intended for ERISA’s fiduciary responsibilities to apply when a plan directly retains an investment manager, but not when a manager is retained indirectly through a plan’s investment in a fund.^[1] Accordingly, under the Plan Asset Regulations, when an ERISA plan acquires an equity interest in an entity that is neither publicly traded nor a security issued by an investment company registered under the Investment Company Act of 1940 (e.g., a mutual fund), the assets of the ERISA plan investor include its acquired equity interest as well as an undivided interest in all of the underlying assets of the entity unless an exemption applies.^[2] This is often referred to as “look-through plan asset treatment,” and it can have severe consequences for the unknowing fund manager.

Exemptions to Look-Through Plan Asset Treatment

In simple terms, the purpose of the Plan Asset Regulations is to prevent investment fund managers from circumventing ERISA's investment-related rules by providing investment services indirectly to ERISA plans (i.e., to entities in which ERISA plan investors invest). However, the Plan Asset Regulations provide exemptions from look-through plan asset treatment to certain types of entities, including certain investment funds as further described below.

Operating Companies

Traditional Operating Companies

Look-through plan asset treatment does not apply to traditional operating companies. If an ERISA plan makes an equity investment in a traditional operating company, its investment includes only its equity interest in the operating company rather than an undivided interest in all the operating company's underlying assets.

An operating company is defined as a company primarily engaged in the production or sale of goods or services directly, or through a majority-owned subsidiary(ies). For example, a company that makes widgets is an operating company. This exception makes sense because an ERISA plan that invests in an operating company does not indirectly avail itself of investment services.

VCOCs and REOCs

The Plan Asset Regulations provide that two types of investment funds—venture capital operating companies ("VCOCs") and real estate operating companies ("REOCs")—are considered operating companies because they are more similar to traditional operating companies than pure investment funds, and, as a result, these hybrid type funds are exempt from look-through plan asset treatment. Note that both exemptions are largely based upon the types of investments the fund makes, and the activity in which the fund engages as a result.

A fund will qualify for the VCOC exemption if, on the date of its first long-term investment and on at least one day during each annual valuation period thereafter,^[3] at least 50% of its assets are invested in operating companies (other than VCOCs) with respect

to which the fund has management rights (referred to as “venture qualifying investments”).^[4] The fund must also exercise its management rights over at least one of those operating companies in the ordinary course of business during each year. Management rights are direct contractual rights held by the fund to substantially participate in or influence the conduct of the operating company’s management.^[5]

As long as a fund’s investment strategy is to invest in operating companies, the fund will be able to comply with the requirements of the VCOC exemption with relative ease. Additional flexibility is afforded to a VCOC during the period that it makes distributions to its investors, which lasts through the earlier of the date it makes a new portfolio investment or 10 years. However, note that if a fund does not structure its first long-term investment as a qualifying VCOC investment, the fund can never qualify as a VCOC. As a result, fund managers who intend to utilize the VCOC exemption should pay particular attention to structuring the fund’s first long term investment correctly.

The REOC exemption is similar to the VCOC exemption. For a fund to qualify as a REOC, at least 50% of its assets must be invested in qualifying real estate as of the date of its first long-term investment and on at least one day during each annual valuation period that follows. Like a VCOC, a REOC’s first investment must be in qualifying real estate to qualify for the exemption. In addition, the fund must possess and actually exercise the right to directly manage or develop the real estate in its ordinary course of business.

The Department has made clear in the preamble to and in an example in the Plan Asset Regulations that a fund will not fail to be a REOC solely because independent contractors are used in real estate management or development activities, provided that the independent contractors remain subject to supervision and termination by the fund. Whether a particular entity’s own employees engage in development or management activities is only one factor used to determine whether the entity is actively managing or developing real estate.

The Department noted that whether a fund is engaged in management or development activity must be determined on a case by case basis. However, two examples inform this analysis. One example clarifies that a fund that is invested in property subject to long-term leases under which maintenance and management responsibilities fall on the lessee would not be engaged in management activity. Another example describes a fund that is invested in shopping centers with individual short-term leases and common areas under which the management and maintenance responsibilities are the landlords and concludes the entity is engaging in management activity. Management or development must be more than just assuming the risk of income producing property.

The Insignificant Benefit Plan Investment Exemption

The Plan Asset Regulations also provide that if benefit plan investment in a fund is “not significant” within the meaning of the regulations, the fund will not be subject to look-through plan asset treatment. The exemption exists because the Department believed that a fund which has not particularly solicited ERISA plan investment should be exempt from the rules that directly apply to the investment of ERISA plan assets.

Participation will not be considered significant if benefit plan investors hold less than 25% of the value of *each class* of the fund’s equity interests. While the Department believes this calculation should be “relatively easy,” it is far from straightforward. For example, a benefit plan investor is defined as an ERISA plan, a plan subject to Section 4975 of the Code (including IRAs) and any entity which is deemed to have plan assets under the Plan Asset Regulations (but only to the extent of the percentage of equity interest held by the benefit plan investors in such entity). Additionally, the value of equity interests held by certain persons with discretion or control over the entity, such as the general partner and/or an investment manager and their affiliated entities, are excluded for purposes of the benefit plan investment calculation. The level of participation by benefit plan investors

requires continuous monitoring as the level must be calculated after every new purchase, transfer, or redemption, of any equity interest in the fund. The continuous monitoring requirement is less onerous for private equity funds than it is for hedge funds because private equity ownership tends to be more stable.

For any period that the percentage of benefit plan investors of any class of equity interests in a fund is 25% or more, the fund, and anyone with discretion over the assets of the fund, will be required to comply with the fiduciary standard of care and prohibited transaction rules under ERISA. If, however, the percentage of benefit plan investors drops below and remains less than 25%, the fund, from that point forward (but not retroactively), will no longer be required to comply with the fiduciary and prohibited transaction rules.

Exceptions to the Exemptions

Finally, in a word of caution, the Plan Asset Regulations contain certain rules that override the exemptions. For example, an asset wholly owned by an ERISA plan investor will always be considered a plan asset even if it is a REOC.

Determining Plan Asset Status

In light of the foregoing, it is critical that the fund manager determines in advance whether the fund will hold or avoid holding plan assets and, if applicable, on which exemption the fund will rely. As a threshold matter, a sophisticated benefit plan investor will look to the fund's documents for the plan's asset status, and the asset status will determine the underlying provisions that a benefit plan investor will expect with respect to the fund's structure.

Plan Asset Status and Fund Documents

If a private equity fund is structured to hold plan assets, then the general partner and the fund manager will be subject to the ERISA fiduciary standard of care. A private equity fund manager who is an ERISA fiduciary should be appointed as an "investment manager" within the meaning of Section 3(38) of ERISA and such appointment

requires a written acknowledgement of ERISA fiduciary status. Only certain types of entities, including registered investment advisors, are qualified to serve as a Section 3(38) investment manager. This appointment may be addressed in the operating fund document, i.e., the partnership agreement, or in the subscription agreement.

Due to the risk of prohibited transactions, a fund that holds plan assets will typically be managed pursuant to a statutory or regulatory exemption to ERISA's prohibited transaction rules so that the fund can invest with impunity. A commonly used prohibited transaction exemption in the private equity market is the "qualified professional asset manager" or QPAM exemption.^[6] Often, the fund's operating agreement will address the primary prohibited transaction exemption upon which the fund will rely.

On the other hand, if a private equity fund is not intended to hold plan assets, the fund documents will typically include some sort of undertaking on the part of the general partner to avoid plan asset status (e.g., a covenant to use reasonable or commercially reasonable best efforts to prevent the fund from holding plan assets). Often, the fund will preserve flexibility by allowing the general partner to use any of the three exemptions (VCOC, REOC or Insignificant Benefit Plan Investment) rather than naming one specifically.

Historically, private equity funds formed to be VCOCs or REOCs issued annual opinions to investors regarding such status. Over time, it has become more common to provide an initial opinion as to VCOC or REOC status as of a fund's first long-term investment, but only annual certifications with respect to status thereafter. Fund documents will typically require the general partner to promptly notify ERISA plan investors if the fund is deemed to hold plan assets. If the plan asset issue is not resolved within the fund's specified cure period, an ERISA plan investor may be able to exercise a limited right to withdraw from the fund or to cease making contributions. Private equity funds that rely on Insignificant Benefit Plan Investment as a primary or secondary exemption will typically have document provisions allowing the fund to force the redemption of benefit plan investors on a pro rata basis in order to cure any plan asset issues.

Sophisticated ERISA plan investors will be especially interested in other provisions of the fund documents as well. For example, ERISA plan investors will look for language preventing the general partner from being able to amend the fund's ERISA-related provisions without the consent of a majority of the ERISA plan investors. In addition, ERISA investors will often seek assurances that the fund's alternative investment vehicles offer the same or substantially similar ERISA protections as provided under the main fund document. Due to the risk of prohibited transactions, ERISA plan investors will generally request an exception to distributions in-kind if they would cause the plan to engage in a prohibited transaction. And because ERISA imposes disclosure and reporting obligations on plans, they will want assurances that necessary fund-related information will be provided.

If you have questions about the Plan Asset Regulations as they relate to private equity funds, please contact [Sarah Lowe](#) or any attorney with Frost Brown Todd's [Employee Benefits & ERISA](#) practice.

[1] The Department also observed that such a conclusion would be "inconsistent with the broad functional definition of 'fiduciary' in ERISA if persons who provide services that would cause them to be fiduciaries if the services were provided directly to plans are able to circumvent the fiduciary responsibility rules of [ERISA] by the interposition of a separate legal entity between themselves and the plans (for example, by providing services to a limited partnership in which plans invest)."

[2] The Plan Asset Regulations also apply to non-ERISA plans, such as IRAs, that are subject to the largely parallel fiduciary and prohibited transaction provisions of the Section 4975 of the Code.

[3] An annual valuation period is a pre-established annual period of no more than 90 days and begins no later than the anniversary of an entity's first long term investment.

[4] Derivative investments can also count toward the 50% ratio. Derivative investments are venture capital investments for which management rights have ceased in connection with the operating company's public offering or have been exchanged for other

investments in connection with a public offering, merger or reorganization.

[5] Contractual rights will not constitute management rights for purposes of the exemption if they run to multiple investors or if they are held by a fund's holding company as opposed to the fund itself.

[6] See Department of Labor Prohibited Transaction Class Exemption 84-14, amended.

© 2026 FBT Gibbons LLP. May be considered attorney advertising in some jurisdictions.