It’s November 11th, Do You Know When Your Private Investment Fund’s VCOC Annual Valuation Period Is?

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Similar to the old school public service announcements that used to tell us the time of day and asked us if we knew where our children were, Proskauer wants to make sure fund managers are complying with their applicable “venture capital operating company” (“VCOC”) obligations.

A manager of a private investment fund that accepts investments from plans or accounts (“ERISA Plans”) that are subject to the U.S. Employee Retirement Income Security Act of 1974, as amended (“ERISA”), will be considered to hold “plan assets” under ERISA and will be subject to ERISA’s fiduciary duties and prohibited transaction rules, unless the fund is structured and managed in compliance with a “plan assets” exception. Given that compliance with ERISA’s fiduciary duties and prohibited transaction rules can be complex, burdensome and/or impossible (depending on the fund’s strategy or structure), many private investment fund managers seek to operate their funds in compliance with such an exception so that their funds do not hold “plan assets” and avoid being subject to ERISA.

The Plan Assets Regulation

A regulation issued by the U.S. Department of Labor at 29 C.F.R. § 2510.3-101, as modified in application by Section 3(42) of ERISA (the “Plan Assets Regulation”), defines the term “plan assets” as applied to entities in which an ERISA Plan invests, directly or indirectly, such as a private investment fund. The Plan Assets Regulation provides that when an ERISA Plan acquires an equity interest in an entity, and such equity interest is neither a “publicly-offered security” nor a security issued by an investment company registered under the U.S. Investment Company Act of 1940, as amended, the assets of the ERISA Plan include not only the equity interest, but also include an undivided interest in the underlying assets of the entity (i.e., the entity is considered to hold “plan assets” subject to ERISA), unless an exception to this general rule applies.

Said another way, generally speaking, when an ERISA Plan acquires an equity interest in a private investment fund, that fund will be considered to hold “plan assets” subject to ERISA unless the fund can comply with a “plan assets” exception.

Exceptions Under the Plan Assets Regulation

The two most common ways for a private investment fund to avoid holding “plan assets” are (i) staying under the ERISA 25% limit and (ii) qualifying as a VCOC.

Staying under the ERISA 25% limit generally means at all times limiting participation by ERISA Plans and other “benefit plan investors” (as defined in Section 3(42) of ERISA) to less than 25% of the value of each class of equity interests in the fund (ignoring, for these purposes, investments by the manager of the fund and its affiliates). If staying under the ERISA 25% limit will or may not be possible (or if a fund manager does not want to have to monitor such participation), then VCOC compliance for the fund could be necessary to avoid holding “plan assets” subject to ERISA.

For a fund to qualify as a VCOC, it generally must (i) have at least 50% of its assets valued at cost invested in “operating companies” with respect to which it has the direct contractual right to participate substantially in, or to substantially influence the conduct of, the management of the operating company (the “Asset Test”) and (ii) actually exercise such management rights with respect to one or more such operating companies in the ordinary course of its business.

The determination as to whether a fund qualifies as a VCOC is made at the time when the fund makes its first long-term investment and thereafter during a pre-established annual 90-day testing period (its “annual valuation period”), the first day of which must begin no later than the anniversary of the fund’s first long-term investment. In order for a fund to continue to qualify as a VCOC, the fund generally must satisfy the Asset Test on at least one day during each following annual valuation period (though special rules apply when a VCOC winds up and enters its “distribution period”).

Although a fund manager may select any 90-day period for its fund’s annual valuation period (so long as it commences no later than the anniversary of the fund’s first long-term investment), many fund managers choose the last 90 days of the calendar year (i.e., October 3 – December 31) because it is easy to remember. Further, ERISA Plans that invest in a fund being operated as a VCOC often contractually require an annual certification from the fund manager regarding the fund’s continued compliance with the VCOC requirements. The delivery date for those certifications often coincides with the timing of the annual valuation period, so having an easy period to remember can be helpful to prevent a VCOC certification delivery failure.

Proskauer Perspective

If you have selected the last 90 days of the year as your fund’s VCOC “annual valuation period”, here is your annual reminder to make sure your fund can pass the Asset Test on at least one day during such period. We advise checking on your fund’s VCOC compliance ***before*** you get too close to the end of the annual valuation period, because if action needs to be taken in order for your fund to satisfy the Asset Test (e.g., dispose of a “bad” asset), the more time you have, the better! This also serves as your reminder to prepare and send any required annual VCOC certifications to your ERISA Plan investors.

Regardless of what your fund’s VCOC annual valuation period is, VCOC compliance can be complicated and quite nuanced. Proskauer is always here to help if you need it.

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