

U.S. Department of Labor

Pension and Welfare Benefits Administration
Washington, D.C. 20210



AUG 3 1989

89-15A
Sec. 401

Mr. Erwin Millimet
Stroock & Stroock & Lavan
7 Hanover Square
New York, New York 10004-2594

Re: Identification Number: F-4349G

Dear Mr. Millimet:

This responds to your letter of July 17, 1989, requesting clarification with respect to an issue under the "plan assets" regulation (29 CFR 2510.3-101, 51 FR 41262, November 13, 1986) issued by the Department of Labor (the Department) under the Employee Retirement Income Security Act of 1974 (ERISA). Specifically, your letter concerns the application of the venture capital operating company exception contained in the regulation to an employee benefit plan's initial capital contribution to a venture capital company.

You represent that a limited partnership will be formed for the purpose of making special equity and venture capital investments. It is proposed that the limited partners, including employee benefit plans, will make 10 percent of their capital contributions at an initial closing and the balance in 4 equal installments thereafter. The limited partnership agreement provides that the partnership will comply at all times with the venture capital operating company exception. The funds received as initial capital contributions will be invested in short-term money market investments pending long-term commitments.

In effect, you seek clarification as to whether, upon formation of a partnership that intends to comply with the venture capital operating company exception contained in section 29 CFR 2510.3-101, the funds received as initial capital contributions from employee benefit plans will constitute plan assets prior to the partnership's first "venture capital investment".

Department of Labor regulation section 29 CFR 2510.3-101 clarifies the definition of "plan assets" for the purposes of title I of ERISA. In general, the regulation provides that, in the case of a plan's investment in an equity interest of an entity that is neither a publicly-offered security nor a security issued by an investment company registered under the Investment Company Act of 1940, its assets include both the equity interest and an undivided interest in each of the underlying assets of the entity, unless the entity is an operating company or equity participation in the entity by benefit plan investors is not significant.

The term "operating company" is defined in regulation section 29 CFR 2510.3-101(c) to mean an entity that is primarily engaged, directly or through a majority owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital. The term operating company includes an entity which is not described in the preceding sentence, but

which is a venture capital operating company or a real estate operating company.

Regulation section 29 CFR 2510.3-101(d) provides, in part, that an entity is a "venture capital operating company" for the period beginning on an initial valuation date and ending on the last day of the first "annual valuation period" (in the case of an entity that is not a venture capital operating company immediately before the determination) if on such initial valuation date at least 50 percent of its assets (other than short-term investments pending long-term commitment or distribution to investors), valued at cost, are invested in venture capital investments; and, during such period, the entity, in the ordinary course of its business, actually exercises "management rights" with respect to one or more of the operating companies in which it invests. Section 29 CFR 2510.3-101(d)(5)(i) defines "initial valuation date" as the later of: (A) any date designated by the company within the 12 month period ending with the effective date of this section, or (B) the first date on which an entity makes an investment that is not a short-term investment of funds pending long-term commitment. Section 29 CFR 2510.3-101(d)(5)(ii) defines "annual valuation period" as a preestablished annual period, not exceeding 90 days in duration, which begins no later than the anniversary of an entity's initial valuation date.

As explained in regulation section 29 CFR 2510.3-101 (d)(3)(i), a "venture capital investment" is an investment in an operating company (other than a venture capital operating company) as to which the investor has or obtains management rights. The term "management rights" is defined under regulation section 29 CFR 2510.3-101(d)(3)(ii) to mean 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 preamble to the final plan assets regulation stated that there are any situations where a plan, although nominally investing its assets in a separate entity, is, as a practical matter, retaining the persons who manage the entity to provide investment management services for the plan.¹ The preamble further indicated that limited partnerships have been used more recently as devices for the collective investment of plan assets.² In specifically addressing venture capital operating companies and real estate operating companies, the preamble noted that venture capital companies and many real estate companies have characteristics of both operating companies and investment funds, and that the specific definitions in the regulation were intended to provide guidance in determining whether the operating company exclusion would be available for such companies.³ The Department also expressed the view that the exclusion for venture capital operating companies is based on the Department's determination that the "operating" activities of such companies predominate because they obtain and exercise management rights in portfolio companies that are actively engaged in the production or sale of a product or service other than the investment of capital.⁴

¹ 51 FR 41262.

² Ibid.

³ Ibid., 41270.

⁴ Ibid., 41273.

The Department believes that it would be inconsistent with the plan asset regulation to extend the venture capital operating company exception to a venture capital company prior to a determination that such company has undertaken the types of activities necessary for characterization as a venture capital operating company. Thus, in the Department's view, an entity would not constitute a venture capital operating company for the period prior to its first venture capital investment. Accordingly, the Department is of the opinion that the funds received as initial capital contributions from employee benefit plans by such entity for investment in short-term investments would constitute plan assets during the period preceding the entity's first long-term investment unless the entity qualifies for one of the other exceptions contained in the plan asset regulation.⁵

This is an advisory opinion under ERISA Procedure 76-1. It is subject to the provisions of the procedure, including section 10, relating to the effect of advisory opinions.

Sincerely,

Robert J. Doyle
Director of Regulations and Interpretations

⁵ In this regard, see the significant participation exception to the regulation's "look-through" rule (29 CFR 2510.3-101(f)).