**U.S. Department of Labor** Pension and Welfare Benefits Administration
Washington, D.C. 20210

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95-04A
ERISA SECTION 401(b)

Mr. Robert Stillman
Associate Administrator for Investment
Small Business Administration
409 3rd Street, S.W., Suite 6300
Washington, D.C. 20416

Dear Mr. Stillman:

This responds to your request for guidance regarding the application of the "plan assets" regulation (29 C.F.R. 2510.3-101) issued by the Department of Labor (the Department) under the Employee Retirement Income Security Act of 1974, as amended (ERISA), to Small Business Investment Companies (SBICs). Specifically, discussions between the Small Business Administration (SBA) and the Department highlighted the need to clarify issues regarding the application of the venture capital operating company (VCOC) exception with respect to: (1) the initial capitalization of an SBIC; (2) an SBIC's exercise of management rights with respect to the portfolio companies in which it invests; and (3) the establishment of an SBIC as a separate entity that is wholly-owned by a VCOC.

Under the Small Business Investment Act of 1958, as amended (SBIA), SBICs are financial intermediaries which provide financing to small business concerns for growth, modernization and expansion. Any corporation or limited partnership formed solely for the purpose of operating as a licensee under the SBIA and its regulations may apply to the SBA for a license. In determining whether to issue a license, the SBA considers, among other factors, whether the applicant has sufficient private capital[1] and management expertise for the SBIC to be operated with safety and soundness. An SBIC operates by issuing its securities either directly to the government or to private investors with a government guarantee. This government financing, known as "leverage," may amount to as much as 400 percent of the SBIC's private funds.[2] The proceeds of the SBIC's securities sales are then invested in or relent by the SBIC to finance small business concerns.

Various statutory and regulatory restrictions govern an SBIC's investments and manner of operations. To assure SBICs specialize in financing small business concerns, the SBA regulations provide that SBICs will not operate business enterprises, nor function as holding companies exercising control over small business concerns (13 C.F.R. 107.801(a)). The regulations expressly preclude an SBIC, its "associates" (defined to include a person owning ten percent or more of any class of stock of an SBIC), or any two or more SBICs, from assuming "control" of a small

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[1] Section 302(a) of the SBIA requires that the combined paid-in capital and paid-in surplus of a company licensed on or after October 1, 1992 shall not be less than $2,500,000 or, for a company investing only in socially or economically disadvantaged businesses (Specialized SBICs), not less than $1,500,000. The SBA's regulations have generally increased these minimums to $5 million; $10 million if the applicant plans to issue participating securities.

[2] The most basic type of leverage is a 5 or 10 year debenture that is sold on the public markets and which carries a full faith and credit guarantee of both principal and interest by the U.S. government. Specialized SBICs may also issue nonvoting preferred securities with a 15 year mandatory redemption. In addition, under the 1992 amendments to the SBIA, the SBA may guarantee participating securities which provide for payment of dividends or interest, plus a profit participation to the SBA, when an SBIC has "earnings" (as defined in the SBA regulations).

business concern, except under certain special circumstances set forth in the regulation. The SBA regulations also restrict the management services that an SBIC or its associates may provide to a small business concern receiving financing from the SBIC. An SBIC may provide management services that are "advisory only" (i.e., where the small business concern is free to accept or reject the advice rendered), but must receive prior SBA approval for other types of management services.

On April 8, 1994, the SBA published final regulations (59 Fed. Reg. 16,898) implementing a major new initiative to revitalize the SBIC program by, among other things, attracting pension fund and other institutional investors to the program. The SBA anticipates that applications for SBIC licenses involving significant employee benefit plan investors will typically take one of two forms. Plans may invest directly in a venture capital fund which is licensed as an SBIC. Alternatively, plans may invest in a venture capital fund that "drops down" a second-tier limited partnership, that is licensed as an SBIC, in which the fund is the sole private limited partner. It is anticipated that some of these SBICs will be financed through participating securities, making the SBA a preferred limited partner.

The Department has issued regulations (29 C.F.R. 2510.3-101) defining when a plan's investment in another entity causes that entity's underlying assets to be "plan assets." The plan assets regulation imposes a "look-through rule" based on the premise that, with certain exceptions, when a plan indirectly retains investment management services by investing in a pooled investment vehicle, the assets of the vehicle should be viewed as plan assets and managed in accordance with the fiduciary responsibility provisions of ERISA. The regulation distinguishes pooled investment vehicles, which are subject to the look-through rule, from operating companies, which are not. Because venture capital companies may have characteristics of both pooled investment vehicles and operating companies, a specific VCOC definition is included in the regulation to provide guidance in determining when the operating company exclusion exception is available for a venture capital company.

In general, the plan assets 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 (29 C.F.R. 2510.3-101(a)(2)). The term "operating company" is generally defined in 29 C.F.R. 2510.3-101(c) as 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 operating company exclusion also applies to entities which are separately defined as VCOCs.

To qualify as a VCOC under the Department's plan assets regulation, an entity must invest at least 50 percent of its assets in "venture capital investments" and, in the ordinary course of its business, actually exercise "management rights" with respect to one or more of the operating companies in which it invests. The 50 percent test must be met as of the first date the entity makes an investment that is other than a short-term investment pending long-term commitment, and, thereafter, on any day during a pre-established annual valuation period (29 C.F.R. 2510.3-101(d)). A qualifying "venture capital investment" is an investment in an operating company (other than a venture capital operating company) as to which the investing entity has or obtains management rights. "Management rights" are 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.

Initial Capitalization

In Advisory Opinion 89-15A (Aug. 3, 1989), the Department addressed the status of initial capital contributions by employee benefit plans to a newly formed venture capital company which proposed to invest in short-term money market investments pending long-term venture capital commitments. The Department concluded that the VCOC exception did not apply to the venture capital company during the period preceding its first qualifying venture

capital investment. The Department reasoned that it would be inconsistent with the plan assets regulation to extend the VCOC exception before the venture capital company had undertaken the types of activities required to qualify as a VCOC. Consequently, the Department concluded that, unless some other exception applied, the initial capital contributions from employee benefit plans would constitute plan assets and persons exercising discretionary authority or control over the assets of the venture capital company would be fiduciaries of plans that initially transferred capital to the company.

You indicate that ready access to initial capital contributions is also of concern to applicants for SBIC licenses. In light of A.O. 89-15A, it has been suggested that a venture capital company seeking to qualify as both an SBIC and a VCOC may wish to utilize an escrow arrangement to facilitate initial capital contributions by an employee benefit plan. Questions have arisen, however, regarding the application of the plan assets regulation and ERISA's trust requirement where a venture capital company enters into such an escrow arrangement with an employee benefit plan. In particular, persons with discretionary authority or control with respect to the assets of a venture capital company seek assurance that, until the terms of the escrow are fulfilled, they will not be considered fiduciaries of property placed in escrow by an employee benefit plan, and the underlying assets of the venture capital company will not include plan assets solely by virtue of the escrow arrangement.

As you know, several venture capital companies contemplate using an escrow arrangement to facilitate the initial capitalization of their enterprises. As we understand the contemplated escrow arrangement, a venture capital company would acquire a contingent interest in property placed in escrow by an employee benefit plan, and the plan would acquire a contingent interest in the venture capital company. Only upon full performance of the terms of the escrow agreement would legal title to the escrow property vest in the venture capital company and the plan's interest in the venture capital company become unconditional. Pending full performance of the escrow agreement's stated terms, legal title to the escrow property would remain with the trustee(s) of the investing plan. The escrow agent would hold the escrow property as agent of both the venture capital company and the investing plans, to the extent of their respective interests in the property at any given point in time.

Fiduciary status under ERISA is determined by a functional test. Section 3(21)(A)(i) of ERISA provides, in pertinent part, that a person is a fiduciary of a plan to the extent that he or she exercises any discretionary control or authority with respect to the management of the plan, or exercises any authority or control respecting management or disposition of plan assets. Whether a venture capital company would exercise any authority or control over the assets of a plan by virtue of exercising its contractual rights under an escrow agreement would depend on the terms of the particular agreement. In general, the terms of an escrow agreement would need to make clear that, until all the conditions precedent were met for transferring the moneys held in escrow to the venture capital company, (1) the escrow property would be plan assets and (2) the escrow holder would be a fiduciary to the plan with respect to such assets. In addition, the escrow agreement should specify that the property would be returned to the plan if the conditions precedent to the transfer were not met within a reasonable period of time.[3] It is the view of the Department that an escrow agreement incorporating these elements would not, in the absence of problems raised by other provisions or circumstances, result in the venture capital company or its principals becoming plan fiduciaries with respect to the escrow property.

Nor does it appear that the assets of a plan that is a party to the contemplated escrow agreement would include the underlying assets of the venture capital company. As explained above, the plan asset look-through rule is triggered

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[3] In addition, the Department notes that in order to be effective in preventing the venture capital company from becoming a plan fiduciary, the agreement should provide that the escrow property would not be transferred to the venture capital company until the company supplied proof acceptable to the escrow holder that, upon such transfer, the company would fulfill the criteria necessary to be a VCOC under the regulation.

by an employee benefit plan's investment in an equity interest of another entity (29 C.F.R. 2510.3-101(a)(2)). Under the described escrow arrangement, the plan's interest in the venture capital company is contingent upon full performance of the terms of the escrow agreement. In these circumstances, it is the Department's view that the plan's investment in an equity interest of the venture capital company would not occur until the terms of the escrow agreement have been fulfilled. Until such time, the plan's assets would include the rights embodied in the escrow agreement and legal title to the property placed by the plan in escrow, but would not include any underlying property of the venture capital company.

In view of the plan's interest in the contemplated escrow property, responsible plan fiduciaries must be mindful of ERISA's trust requirement. Section 403(a) of ERISA requires that all assets of an employee benefit plan shall be held in trust by one or more trustees. The Department has promulgated a regulation relating to the trust requirement (29 C.F.R. 2550.403a-1) which contains specific rules regarding how the trust requirement may be satisfied with respect to various kinds of property; the regulation does not, however, separately address property placed in escrow. As the Department explained in promulgating the regulation, there are two primary considerations in determining whether a particular arrangement satisfies the trust requirement: (1) the segregation of the property so as to prevent commingling of the property held in trust with property held for his own account by the person managing the property; and (2) the trustee's retention of the exclusive authority and discretion to manage and control all of the plan's rights with respect to the property. In addition, plan assets must be held in a manner that is consistent with the general fiduciary provisions of ERISA, including the prudence rule of section 404(a)(1)(B).[4] The question whether a given escrow arrangement meets these standards will depend upon the facts and circumstances of the particular arrangement. The Department understands that an escrow holder is absolutely bound by the terms and conditions of the deposit and charged with strict execution of the duties assumed under the escrow agreement. Nevertheless, section 403(a) and the Department's regulations require that the escrow holder either be an agent of the plan trustee or appointed by a named fiduciary as an investment manager of the plan (within the meaning of section 3(38)). Within these requirements, the authorized fiduciaries of the plan should have sufficient flexibility to structure an escrow arrangement which satisfies the trust and prudence requirements of ERISA.

Furthermore, plan fiduciaries contemplating an escrow arrangement to facilitate an investment in a venture capital company must give appropriate consideration to those facts and circumstances that the fiduciaries know, or should know, are relevant to the investment course of action. This would include consideration of the role that the investment course of action plays (in terms of such factors as diversification, liquidity and risk/return characteristics) with respect to that portion of the plan's investment portfolio within the scope of the fiduciary's responsibility. In this regard, the responsible fiduciaries must consider the risk of loss and opportunity for gain (or other return) on the investment course of action as a whole, and accordingly set limits on the time allowed the venture capital company to satisfy the escrow conditions. Because plan assets are committed to the proposed venture capital investment upon their deposit in escrow, the plan fiduciaries must have completed their review of the entire investment course of action before transferring assets to the escrow agent.

Management Rights

A first reading of the SBIC and the VCOC requirements reveals an apparent tension between the two regulations with respect to the exercise of management rights over portfolio companies. On the one hand, the SBA's regulations

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[4] In this regard we note, regardless of which party selected the escrow agent, courts have held that a loss occasioned by the default, peculation, or similar wrong of an escrow holder must, as between the parties, be borne by the one who, at the time of its occurrence, was lawfully entitled to the right or property affected. The Department is not addressing here the question of the extent to which a plan trustee is responsible as principal for the acts of the escrow agent.

generally prohibit an SBIC from exercising control over its portfolio companies. On the other hand, the VCOC exception is premised upon a venture capital company's material participation in the management of its portfolio companies. Upon closer scrutiny, however, the SBA's regulations expressly contemplate that SBICs may provide some forms of management assistance to the small businesses they finance, and the VCOC provisions permit latitude in the type, amount or style of management rights that a venture capital company must acquire and exercise in order to qualify as a VCOC. As discussed below, it appears that the two regulations provide for an area of overlap whereby an entity may qualify as both an SBIC and a VCOC.

"Control" is generally defined in the SBA regulations (13 C.F.R. 107.3) as the direct or indirect possession of the power to direct or cause the direction of the management and policies of an operating company whether through the ownership of voting securities, by contract, or otherwise.[5] The SBA's regulations thus appear to preclude an SBIC from acquiring the power to dictate the management or policies of an operating company. However, these same regulations expressly permit an SBIC to provide "advisory only" and, subject to approval by the SBA, other forms of management services (that are not exclusively advisory) to the small business concerns they finance (13 C.F.R. 107.501).

The Department's plan assets regulation defines "management rights" as 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 (29 C.F.R. 2510-3.101(d)(3)(ii)). However, management rights do not require that a VCOC have the power to direct a portfolio company's management to comply with the VCOC's input, or that any contract providing for management rights require that the VCOC receive compensation for performing management activities. For example, if an SBIC appointed one director to a three (or more) person board the Department would find the requirement that a VCOC obtain management rights satisfied. Similarly, an example in the plan assets regulation describes VCOC managers who "routinely consult informally with" or "advise" management as illustrative of the type of management rights contemplated by the regulation. Accordingly, there appears to be a range of management rights that an SBIC may exercise with respect to its portfolio companies that would be consistent with both the SBIC and VCOC regulations.

Wholly-Owned SBICs of a VCOC

The VCOC exception to the plan asset look-through rule is premised upon the understanding that, in the normal course of its business, a VCOC is involved in management of at least one portfolio company, and that this involvement affects the return on the plan's investment. While typical VCOCs have characteristics of both passive investment funds as well as operating companies, the "operating" activities may be said to predominate because the VCOC obtains and exercises 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. These operating activities distinguish a VCOC from an investment fund which merely selects among investments and thereby, in effect, provides investment advisory services to plans.

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[5] In addition, the SBA regulations (13 C.F.R. 107.801(b)) presume control if the SBIC, its associates, or two or more SBICs own or control, directly or indirectly, voting securities equivalent to:

(1) fifty percent or more of the outstanding voting securities, if held by fewer than fifty shareholders;

(2) more than twenty-five percent, or a block of twenty or more percent which is as large or larger than the largest other outstanding block of such securities, if held by fifty or more shareholders.

During the regulatory process, commentators sought to extend the VCOC exception to a plan's investment in a venture capital company or fund which, in turn, invests in other venture capital companies. In such a venture capital "fund of funds," however, the relationship of the venture capital company to the management of companies that actually produce or sell a product or service is much more remote. The Department, therefore, rejected this approach and expressly excluded VCOCs as qualifying "venture capital investments."[6]

In the view of the Department, the plan assets regulation does not prohibit a venture capital company from establishing a wholly-owned subsidiary SBIC which has no other non-governmental investors. Such an entity would not, in the Department's view, constitute a "fund of funds" or a separate VCOC. Furthermore, if the VCOC retains the requisite management rights in the portfolio companies held by the SBIC, the relationship between the VCOC and its portfolio investments remains direct.[7] The Department, therefore, is of the opinion that the interposition of a wholly-owned subsidiary between a VCOC and its portfolio investments may be disregarded for purposes of the requirement that at least 50 percent of the assets of a VCOC must be invested in venture capital investments. A subsidiary would be treated as "wholly owned" only if 100 percent of the entity's equity is held by a venture capital company, or by a venture capital company and the SBA, at all times during the period such entity is in existence.[8]

Under this interpretation the parent venture capital company would still have to satisfy all other conditions of the regulation in order to be considered a VCOC. This includes the requirement of section (d)(3) of the regulation that a venture capital investment is an investment as to which the investor has or obtains management rights. Management rights are defined in the regulation to be contractual rights directly between the VCOC and the operating company to substantially participate in, or substantially influence the conduct of, the management of the operating company. The regulation makes clear that it is the possession and exercise of management rights which separates venture capital investments from indirect investment services. We should note, however, that in the context of a wholly-owned subsidiary SBIC, direct contractual rights do not necessarily require a separate contract between a VCOC and an operating company. If the VCOC is named in the subsidiary SBIC's investment contract and given management rights thereunder to substantially participate in, or substantially influence the conduct of, the management of the operating company, such rights directly flowing to and independently enforceable by the VCOC would be considered management rights for the purposes of the regulation.[9]

This letter constitutes an advisory opinion under ERISA Procedure 76-1 (41 Fed. Reg. 36281, Aug. 27, 1976). Section 10 of the Procedure describes the effect of advisory opinions.

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[6] See 51 Fed. Reg. 41,273 (Nov. 13, 1986).

[7] The terms "subsidiary" and "parent" as used in this letter are not intended to limit the form of the subsidiary entity or of the venture capital company, but are intended to reflect the relationship between the two entities.

[8] For purposes of determining whether a VCOC holds 100 percent of an entity's equity, the Department will disregard any de minimis holdings by a general partner held solely to comply with the minimum safe harbor requirements established by the Internal Revenue Service for classification as a partnership for federal tax purposes.

[9] In the preamble to the regulation, the Department made clear that different entities investing in a single operating company could obtain different kinds of management rights. Therefore, a subsidiary SBIC may obtain or exercise any additional management rights respecting an investment; obtaining or exercising such rights would in no way affect the status of the VCOC.

Sincerely,

Robert J. Doyle
Director of Regulations and Interpretations