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New ERISA Reporting and Disclosure Rules and Guidance Appear to Favor VCOC/REOC Compliance over 25% Test Reliance

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The U.S. Department of Labor ("**DOL**") has issued new guidance in the form of answers to Frequently Asked Questions ("**FAQs**") relating to changes to Form 5500 (the annual report filed by ERISA plans with DOL) that it adopted in an effort to increase the transparency of direct and indirect fees and expenses borne by ERISA-covered plans in connection with their investments. To the consternation of many sponsors of investment funds that are typically exempt from ERISA regulation, these new reporting and disclosure requirements reach certain investment funds that do not hold "plan assets" for purposes of ERISA.

The changes to Schedule C of Form 5500, as explicated in the FAQs, significantly expand the reporting to the DOL of direct and indirect compensation paid to ERISA plan service providers.

One surprising aspect of these new rules is that they appear to apply to investment funds that rely on the "25% Test" for their exemption from ERISA, while investment funds that qualify as "venture capital operating companies" ("**VCOCs**") or "real estate operating companies" ("**REOCs**") are specifically exempt from these rules.

Form 5500 Service Provider Compensation Reporting

DOL's changes to Schedule C of Form 5500 require every plan to provide specific information regarding any service provider who received direct or indirect compensation in excess of $5,000 during the plan year, including the name and EIN of the service provider and the amount of compensation received from the plan. This includes such "indirect compensation" as compensation paid by an investment fund in which an ERISA-covered plan had invested to the investment fund's investment adviser or investment manager, fees paid by the investment fund relating to purchases and sales of interests in the fund, and certain other fund-level expenses. While not expressly identified, presumably carried interest distributions received by the fund's general partner or its affiliate would be reportable as well.

Certain "eligible indirect compensation" (a concept which includes investment management fees, brokerage fees, recordkeeping fees and certain other compensation received at the fund level) received by a service provider to an investment fund need not be specifically reported on the Form 5500 if the plan administrator attests to having been furnished with specific information regarding such compensation that the plan administrator reviews at least annually. Each recipient of such "eligible indirect compensation" would be identified on the Schedule C filed with DOL.

The Form 5500 changes go into effect for plan years beginning on or after January 1, 2009, such that the information required to be provided by service providers to ERISA plans to satisfy these obligations will need to be reported beginning in 2010.

Extension of Changes to Non-Plan Asset Vehicles

As indicated above, in the case of the Form 5500 reporting changes, a key element of DOL's effort to increase transparency is to extend the reach of the reporting and disclosure requirements to investment products that do not hold "plan assets", including, most prominently, registered mutual funds. However, the rule changes affect, or potentially could affect, not only mutual funds, but other investment funds in which ERISA plans invest, including private equity, real estate, and hedge funds.

A significant number of real estate and private equity funds traditionally structured their funds as VCOCs or REOCs for purposes of ERISA in accordance with the DOL's "plan asset regulations" issued in 1986. Operating a fund as a VCOC or REOC ensures that the operations of the fund are not subject to regulation under ERISA. An alternative exemption in the plan asset regulations is the "25% Test", whereby investment funds with less than 25% participation by "benefit plan investors" are exempted from ERISA regulation. A fund complying with the 25% Test need not operate as a VCOC or a REOC to avoid ERISA regulation. The Pension Protection Act of 2006 ("**PPA**") made it easier for investment funds to satisfy the 25% Test by specifically excluding governmental and offshore pension funds from the definition of "benefit plan investors". Many sponsors of investment funds that might have previously relied on the VCOC or REOC exemptions have found it less burdensome and costly to operate under the 25% Test. Given the PPA's exclusion of governmental funds in particular (which are frequent and significant investors in private equity and real estate funds), many fund sponsors have found that compliance with the 25% Test does not meaningfully interfere with their capital raising objectives and is thus an attractive alternative to VCOC or REOC compliance.

DOL's New Rules May Cause Fund Sponsors to Rely on the VCOC/REOC Exemptions, Rather Than the 25% Test

Regardless of whether a fund is structured as a VCOC or REOC or relies on the 25% Test, the net effect of meeting either of these exceptions has historically been the same -- the assets of the fund are not plan assets and therefore the general partner and manager of the fund are not plan fiduciaries and the operations of the fund are not subject to ERISA's fiduciary responsibility requirements and prohibited transaction restrictions.

However, the FAQs released by DOL in July 2008 appear to have created a meaningful distinction between reliance on the VCOC/REOC exemptions as opposed to the 25% Test. This is because a fund relying on the 25% Test may be considered an "investment fund" for purposes of the new Form 5500 rules, and thus fall into the indirect compensation reporting requirements of these rules, whereas VCOCs and and REOCs are expressly exempt from these rules according to the FAQs. In this regard, DOL clarified that regardless of whether a particular "investment fund" holds plan assets, certain service providers to such investment funds, including recipients of investment management fees, brokerage fees and fees paid for recordkeeping services, among others, are required to be included in the Form 5500 report.

DOL specifically indicated in the FAQs that while registered mutual funds (which do not include "plan assets" by statute) are "investment funds" covered by these rules, VCOCs and REOCs are not. Thus, fees "received by third parties from operating companies including [REOCs or VCOCs] in connection with managing or operating the operating company generally would not be reportable indirect compensation." While the DOL identified mutual funds (which do not hold plan assets), and bank common and collective trusts and insurance company pooled separate accounts (which do) as "investment funds", it did not address whether funds that rely on the 25% Test exception, but are not operated as VCOCs or REOCs, would be considered "investment funds" for purposes of the Form 5500 reporting rules. The DOL also did not elaborate on its thinking in creating the distinction for operating companies (VCOCs and REOCs). However, it appears that DOL is expressly and singularly distinguishing "operating companies" from "investment funds" -- as evidenced by its indication that even operating companies wholly-owned by a plan need not be covered by the reporting.

In light of this new distinction, it appears prudent to view the DOL's guidance that service providers to operating companies need not be included in the Form 5500 reporting as limited to operating companies and, therefore, that funds relying on the 25% Test would be considered "investment funds" covered by the new reporting requirements. Consequently, a real estate or private equity fund that has the flexibility to operate either as an under-25% fund or a VCOC/REOC should consider whether to elect the latter in order to avoid the possibility of being swept into the ambit of required reporting and scrutiny by DOL of its fee and compensation arrangements. At a minimum, such fund sponsors will now need to carefully consider and weigh whether the costs and burdens of VCOC/REOC compliance outweigh these new reporting requirements and the attendant possibility that compensation paid by real estate and private equity funds to their investment managers, general partners and other service providers may come under regulatory scrutiny. We note that hedge funds, which typically cannot avail themselves of operating company status, appear to be swept into the "investment fund" category with their registered mutual fund counterparts, regardless of whether the hedge fund has avoided plan assets status through reliance on the 25% Test.

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We will continue to monitor these developments at DOL and report on further guidance on this issue. In the meantime, should you have any questions regarding the above or wish to discuss further please contact:

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