MEMORANDUM

TO: File
FROM: James P. Sinnott
RE: Business conduct consultation with Groom Law Group
DATE: August 30, 2010

On August 30, 2010, Lourdes Gonzalez, Joanne Rutkowski, Cindy Oh, Rich Ferlauto, Doug Scheidt and Christine Sibille of the Securities and Exchange Commission and Phyllis Cela, John Dolan, Katherine Driscoll, Ted Kneller, Barry McCarty, Michael Solinsky and Vivek Jain of the Commodities Futures Trading Commission consulted with Ian Lanoff and Richard Matta of Groom Law Group, Jeanine Markoe Raymond (Director of Federal Relations, NASRA), Leigh Snell (Director of Federal Relations, National Council on Teacher Retirement), Jane Hamlett (State of Wisconsin Investment Board), and Richard Dahl (Mosier's).

The participants provided an overview of potential areas of concern regarding the rulemaking required under the Dodd-Frank Act, including the interaction of the business conduct requirements and the provisions of the Employee Retirement Income Security Act of 1974. The Groom Law Group also distributed 2 articles that were written by principals of their firm.

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REPORTER

Dodd-Frank Meets ERISA— The Impact of Wall Street Reform on Plan Investments



BY JENNIFER ELLER, RICHARD MATTA, AND ROBERTA UFFORD

In his remarks upon signing into law the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] (the Act) on July 21, 2010, President Obama said, "Now, for all those Americans who are wondering what Wall Street reform means for you, here's what you can expect."[2]

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173ENR/pdf/BILLS-111hr4173ENR.pdf.

[2] Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act, July 21, 2010 (available at: http://www.whitehouse.gov/the-press-office/remarks-president-signing-dodd-frank-wall-street-reform-and-consumer-protection-act).

The authors are principals of Groom Law Group, Chartered, a law firm that specializes in employee benefits law located in Washington, D.C.

Paraphrasing the words of the President—for all those employee benefit plan fiduciaries who are wondering what Wall Street reform means for you, here's what you can expect.[3]

1. New requirements will apply to interest rate swaps and other derivatives transactions entered into by and on behalf of employee benefit plans. Stable value contracts will not be regulated as swaps, at least initially.

2. Most advisers to hedge funds and private equity funds will have to register with the Securities and Exchange Commission (SEC") and even those already registered will have to collect and report more information.

[3] While other aspects of the Act could affect plans and plan sponsors, (e.g., the new requirements on public companies enhancing shareholder rights and disclosure of executive compensation, and the establishment of a new Bureau of Consumer Financial Protection) we've chosen to address in this article those aspects of the bill most related to plan investments.

3. New limits on bank investment and related activities could affect the activities of banks and their affiliates on behalf of employee benefit plan customers.

4. We won't know the full impact of the 1500-page Act until we start seeing implementing regulations from, among others, the SEC, the Commodities Futures Trading Commission (CFTC), and the Federal Reserve and other banking regulators. Nevertheless, there are a few steps plan fiduciaries should consider taking now, and some things to keep in mind for the future. We note these throughout the article and highlight them at the end.

A. Regulation of Over-the-Counter Swaps

Title VII of the Act, the Wall Street Transparency and Accountability Act, establishes a new regulatory framework for the derivatives market and will impose substantial new regulation on transactions designated as "swaps" and on certain swap market participants. Transactions covered by the new regulatory framework will include a broad range of "derivative" instruments commonly referred to as swaps, puts, caps, and collars relating to commodities, currencies, securities, securities indices and other financial instruments, "synthetic" contracts, and financial or economic interests of any kind based on future performance or notional amounts.

Among other things, the Act extends the jurisdiction and broadens the authority of the SEC, the CFTC and banking regulators over, and imposes significant new rules on, a broad range of privately negotiated (over-the-counter) or (OTC) transactions defined as "swaps" (CFTC jurisdiction) or "securities-based swaps" (SEC jurisdiction).[4] With limited exceptions, swaps will need to be standardized and settled through a registered clearinghouse.[5] Swaps not settled through a clearinghouse will still be subject to reporting requirements.[6] Persons acting as "swap dealers" and "major swap participants" will be required to register with the CFTC and/or SEC and subject to substantial new requirements regarding capital, margin deposits, disclosure (transparency), and conflicts.[7] The Act will also prohibit future bailouts of swap dealers and major swap participants.[8]

As investors, retirement plans and other employee benefit plans and the pooled investment vehicles in which plans invest use swaps and other derivatives for a range of investment purposes. Therefore, regulation of counterparties to plan transactions could substantially alter the terms and conditions, and costs, for plans engaging in swaps and other covered transactions. Accordingly, plans are likely to see the impact of the new regulation of these transactions as the new rules are implemented.

Importantly, as modified in conference, the Act substantially mitigates the potential effects of certain provisions in early versions of financial services reform that were of particular concern to the benefit plan community. Some provisions of key interest to plan fiduciaries are as follows:

[4] Act, § 712.
[5] Act, § 723(a)(3).
[6] Act, § 729.
[7] Act, § 731.
[8] Act, § 716.

■ Treatment of stable value fund "wrap" contracts was a key issue for participant-directed 401(k) and similar plans. Stable value funds are a popular investment option offered to plan participants; there was concern that wrap contracts and other contracts providing a "benefit-responsive guarantee" to support stable value fund accounting could be regulated as "swaps." As modified in conference, the Act temporarily exempts stable value contracts from regulation as swaps and permanently grandfathers stable value contracts existing as of the date of enactment.[9] The SEC and CFTC, in consultation with the Department of Labor, the Treasury Department and state insurance regulators, must determine within 15 months of enactment whether stable value contracts fall within the definition of a "swap."[10] If they determine that they do, they must make a further determination of whether stable value contracts should be exempted from the Act.[11]

■ Employee benefit plans generally will be exempted from the definition of "major swap participant" when engaging in swaps "for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan."[12] The scope of this exception is unclear; for example, plans regularly engage in swaps for purposes that might be viewed as other than hedging or mitigating risk, such as certain portfolio restructurings. Also, it is not clear whether the exception applies only to plans themselves, or also to entities holding "plan assets," including master trusts and group trusts.

■ One of the most controversial provisions of the Senate Bill would have imposed a "fiduciary duty" (over and above new business conduct standards) on swap dealers who provide advice to, offer to enter into swaps with, or actually enter into swaps with private or governmental retirement plans and endowment funds.[13] There was significant concern that this provision would create insurmountable conflicts of interest for swap dealers so as to prevent them from transacting business with plans. As modified in conference, the Act instead imposes requirements on swap dealers and major swap participants who act as advisers to or counterparties to "Special Entities" (including ERISA plans, governmental plans and endowments).

— Where a swap dealer or major swap participant advises a Special Entity, these requirements make it unlawful to defraud the Special Entity, and impose an affirmative duty on the adviser to make reasonable efforts to obtain information to determine that the recommended swap is in the Special Entity's best interest in light of the Special Entity's financial status, tax status and investment objectives.[14]

— Where a swap dealer or major swap participant is a counterparty to (or offers to be a counterparty to) a Special Entity, the Act requires that, prior to entering into the swap, a swap dealer must have a reasonable basis to believe that the Entity is represented by someone who (i) has sufficient knowledge to evaluate the risks of the transaction; (ii) is not "disquali-

[9] Act § 719(d).
[10] Act § 719(d)(1)(A).
[11] Act § 719(d)(1)(A).
[12] Act § 721(a)(33)(i)(II).
[13] Act § 731, adding Commodity Exchange Act (CEA) § 4s(h)(2).
[14] Act § 731, adding CEA § 4s(h)(2)(A)(4).

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fied" from representing the Entity; (iii) is independent of the swap dealer; (iv) has a (fiduciary) duty to act in the best interest of the Entity; (v) makes appropriate disclosures; (vi) makes a written determination regarding fair pricing and appropriateness of the transaction; and (vii) in the case of an ERISA-governed plan, is a fiduciary. Notably, the Act's legislative history makes clear that while the person representing a Special Entity must be independent of the Special Entity's counterparty, it is not necessary for the representative to be independent of the Special Entity itself (*i.e.*, an outside manager is not required).[15] These rules do not apply to swaps initiated by a Special Entity of its own accord via an exchange, or which are conducted as "blind" transactions.[16]

■ The full scope of transactions that will be covered by the new regulatory framework remains to be seen, and is likely to result in new uncertainty for some plan transactions. Exceptions will be available for instruments subject to regulation as securities, true debt instruments, certain bank products, and certain agreements that anticipate settlement by actual delivery of a commodity or a security, or an agreement with an issuer designed to raise capital. For instance, it is unclear to what extent derivative contracts covered by new regulation may include common "participation" interests in loans or leases, or to guarantees. Arguably, however, the exception for capital raising should allow for typical "carried interest" or "performance fee" arrangements.

B. Regulation of Advisers to Private Investment Funds

The Private Fund Investment Advisers Registration Act of 2010 (Title IV of the Act) amends the Investment Advisers Act of 1940 (the Advisers Act) to eliminate (with some exceptions) the "private fund" exemption from the registration requirements of the Advisers Act.[17] Currently, advisers with fewer than 15 clients are not required to register or be regulated as investment advisers.[18] For this purpose, an "investment fund" such as a hedge fund with multiple investors is typically treated as a single client. Accordingly, advisers to hedge funds, private equity funds, and other "private funds" excepted from registration as investment companies under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (Investment Company Act) have traditionally relied on this exemption to avoid regulation as investment advisers.

The elimination of the private fund exemption will require most advisers to private funds to register with the SEC and also subject these advisers (whether previously registered or not) to new reporting, disclosure, and examination requirements. For example, many private fund advisers will be required to report to the SEC about assets under management, use of leverage, counterparty credit-risk exposure, trading and investment positions and practices, valuation policies and practices, types of assets held, side letters, and any other information the SEC deems necessary.[19]

Elimination of the "private fund" exemption will not change requirements with respect to bank collective trust funds and other investment vehicles maintained solely for investment by tax-qualified plans, which generally are exempted by Section 3(c)(11) of the Investment Company Act.[20] In addition, the Act provides some limited exemptions from Advisers Act registration, including (among others) exemptions for venture capital fund advisers and advisers to so-called "family offices."[21] Also exempted from Advisers Act registration are private equity and other private fund advisers who (a) do not advise funds other than private funds and (b) have less than $150 million in assets under management in the United States. This provision represents a change from earlier versions of the legislation, which would have exempted even large private equity fund managers from Advisers Act registration requirements.[22] The exact scope of these exemptions will be addressed in regulations to be issued by the SEC.

Rules governing whether an adviser may register with the SEC or must instead register in each of the states in which it conducts business are also changed.[23] Current law provides that an investment adviser generally may not register with the SEC unless it has more than $30 million in assets under management or would be required to register in 30 or more states. Under the Act, an adviser with assets between $30 million and $100 million may not register with the SEC (and must register in the state(s) in which it conducts business) unless the adviser would be required to register with 15 or more states.[24]

Finally, Title IV makes some adjustments to requirements for the qualification of investors in private funds.[25] For now, these changes primarily affect whether "natural persons" will meet "accredited investor" status, but additional changes may be expected. In this regard, the Act requires the SEC and Comptroller General to conduct reviews or studies of net worth thresholds to be applied to investors in private funds, and requires the SEC to adjust the "qualified client" test for the effects of inflation.[26]

Elimination of the private fund exemption from Advisers Act registration and other changes made by Title IV of the Act could have several consequences for plans, including:

■ Many hedge fund managers and private equity managers not already registered will need to do so. Notably, even non-U.S. based advisers to foreign funds could be subject to the new registration requirements if they do not qualify as a "foreign private adviser" under the Act.

■ Importantly, newly registered advisers and advisers that are currently registered will be required to maintain and file new types of information with the

[15] Act § 731, adding CEA § 4s(h)(2)(A)(5).
[16] Act § 731, adding CEA § 4s(h)(2)(A)(7).
[17] Act, § 403.
[18] 15 U.S.C. § 80b-3(b).

[19] Act, § 404.
[20] Section 402 of the Act adds a definition of the term "private fund" to the Advisers Act by reference to §§ 3(c)(1) and 3(c)(7) of the Investment Company Act.
[21] Act, §§ 407, 409.
[22] Act, § 408.
[23] Act, § 410.
[24] Act, § 410.
[25] Act, § 413(a).
[26] Act, §§ 413(b), 415, 418.

SEC, much of which will be of interest to the adviser's clients, including plans and plan fiduciaries.

■ Plan sponsors who may themselves be in the business of advising others should consider the impact of SEC regulation with respect to the advisers' own plans. As noted above, the SEC will be required to issue rules regarding the exemption of mid-size advisers (e.g., those who "solely" advise private funds and whose assets under management are less than $150 million). (A similar rulemaking will take place with respect to "family offices" under Section 409 of the Act.) In these rulemakings, the SEC will likely be faced with the question of how to treat an adviser's own plans. For instance, should a mid-size adviser who advises the employee benefit plans it sponsors be required to register? Will a family office fail to meet the requirements of an SEC exemption merely because it sponsors and advises an employee benefit plan for employees of the family office?

■ Plan sponsors that are not currently engaged in an investment advisory business (and not registered as investment advisers) but who may be deemed to "advise" the employee benefit plans they sponsor, or foundations or endowments with which they have a relationship, should consider the possible implications of the elimination of the private fund exemption and future SEC regulation on employers as advisers. The SEC staff has previously issued interpretations that plan sponsors whose employees advise the sponsor's own plans on investments could meet the definition of an "adviser" for purposes of the Advisers Act, while also indicating that plan sponsors generally need not register under the Advisers Act (based in part some cases on the "private fund" exemption). With the private fund exemption no longer available, there is a possibility that the SEC could review whether some plan sponsors no longer qualify for exemption from the Advisers Act registration requirements.

Provisions under Title IV of the Act generally are effective one year after the date of enactment, although advisers may be able to register early during a one-year transition period.[27] Fiduciaries of plans investing in hedge funds and other private funds with advisers that may be newly subject to registration requirements may wish to consider contacting these fund managers to learn about the manager's strategy for addressing new registration or recordkeeping requirements applicable to the manager. Plan sponsors and advisers may also want to review and update side letter provisions to reflect new SEC requirements, when finalized.

C. Ban on Certain Bank Entities Investing in, or Sponsoring, Private Funds (the Volcker Rule)

Title VI of the Act creates a new section 13 of the Bank Holding Company Act, which, during the legislative debate, became known as the "Volcker Rule." The provisions impose new requirements on any "banking entity" including the investment and trading activities of an insured depository institution, a company that directly or indirectly controls an insured depository institution, a company treated as a bank holding company, or any subsidiary of such an institution or company (Banking Entity).[28] The Volcker Rule will prohibit any Banking Entity from engaging in "proprietary trading," including transactions in stocks, bonds, options, commodities, derivatives, or other financial instruments for its own trading book.[29] However, Banking Entities will be permitted to (among other things) engage in trading on behalf of a customer and market making activities or trading "otherwise in connection with customer relationships, including risk-mitigating hedging activities related to such customer transactions."[30]

In addition, because an insurance company affiliate of a bank is deemed to be a Banking Entity for purposes of the Act, the Act contains a special carve-out from the proprietary trading prohibition for insurance company general account investments.[31] There is no specific carve-out for investment activities of insurance company separate accounts (the assets of which are also legally owned by the insurance company), so questions have arisen regarding whether separate account investments might be captured under the "proprietary trading" ban. While this question may be the subject of future rulemaking, it seems likely that, for now, insurance companies might reasonably take the view that separate account investments are undertaken "on behalf of customers" and therefore permitted under the Act.[32]

Section 619 will also prohibit a Banking Entity from "sponsoring" or investing in a hedge fund or private equity fund (defined as any entity or fund exempt from registration under Section 3(c)(1) or 3(c)(7) of the Investment Company Act or any similar fund).[33] "Sponsoring" a fund is defined broadly to include serving as general partner, managing member, or ***trustee*** of a fund; selecting or controlling a majority of the fund's directors, trustees or managers; or sharing its own name for purposes of marketing, promotion, etc. (private labeling).[34] The effective date for this provision is the earlier of one year after regulations are issued by the federal bank regulatory agencies (required within nine months after the new Financial Stability Oversight Council completes a study of new rules affecting Banking Entities) or two years after the date of enactment.[35] The bank regulatory agencies could approve a maximum of three individual one-year extensions if not detrimental to the public interest.[36]

There were concerns under the Senate version of the Act that the Volcker Rule prohibition on banks sponsoring private funds could have reached certain types of commingled benefit plan trusts, e.g., VEBAs, group trusts, multiple employer plan trusts, and other investment vehicles for plans that may rely on (in part or entirely) private fund exemptions under Sections 3(c)(1) and 3(c)(7) of the Investment Company Act. Many of those vehicles, in turn, have bank trustees, which might have been forced to resign under the Senate Bill. (Most "single employer" retirement plan trusts (including master trusts) are either not investment companies at all, or are exempt from registration for ***other*** reasons,

[27] Act, § 419.

[28] Act, § 619, adding BHCA § 13(h)(1).
[29] Act, § 619, adding BHCA § 13(a)(1)(A).
[30] Act, § 619, adding BHCA § 13(d).
[31] Act, § 619, adding BHCA § 13(d)(1)(F).
[32] Act, § 619, adding BHCA § 13(d)(1)(H).
[33] Act, § 619, adding BHCA §§ 13(a)(1)(A), (h)(2).
[34] Act, § 619, adding BHCA § 13(h)(5).
[35] Act, § 619, adding BHCA § 13(c)(1).
[36] Act, § 619, adding BHCA § 13(c)(2).

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e.g., based on the exemption under Section 3(c)(11) of the Investment Company Act, and would not have been affected. Collective trust funds and pooled separate accounts also generally rely on the Section 3(c)(11) exemption.)

Fortunately, the final version of the Act contains several changes that should permit banks to continue to serve as trustee and provide other services to most commingled benefit plan trusts. First, the rule now defines a covered "banking entity" to ***exclude*** any FDIC-insured institution acting only in a fiduciary capacity (i.e., a limited purpose trust company).[37] Second, "sponsoring" a hedge or private equity fund does not include any activity engaged in by a banking entity if: the bank is acting ***only*** in the capacity of a bona fide trustee, fiduciary or investment adviser; it is offering the fund ***only*** to its bona fide fiduciary customers; it makes no more than a de minimis personal investment in the fund; and it satisfies certain other conditions.[38] The full extent of this exception has yet to be determined, though it very much resembles existing law as it relates to the investment of bank fiduciary customers in common trust funds.[39]

Federal banking agencies and the SEC are directed to adopt regulations to carry out the Volcker Rule; it will be important for financial institutions and plan fiduciaries to monitor the rulemaking process so that plan investment activities will not be disrupted.

What Plan Investment Fiduciaries Should Do

Further paraphrasing the words of the President in signing the Act, now that we've discussed what plan fiduciaries need to know about Wall Street reform, what is to be done? Here are some ideas:

1. Swaps and Derivatives provisions:

■ Review plan investments in swaps and other derivatives. Does the plan manage its derivatives investments in-house, or use an outside investment manager? In either case, plan fiduciaries need to be educated about the new settlement and clearing requirements.

■ Communicate with managers and counterparties regarding new standards applicable to persons advising and dealing with plans in swap transactions.

2. Investment Advisers Act amendments:

■ Review plan investments in private equity, hedge funds and other similar funds. Discuss with fund managers how they expect to address the new registration, reporting, and recordkeeping requirements.

■ Review side letters with private fund managers and consider whether any "most favored nations" or informational provisions are triggered by the new legal requirements. When making new investments in private funds, consider adding side letter provisions incorporating disclosures based on the new legal requirements on private fund managers.

■ Keep tabs on SEC rulemakings addressing Adviser's Act registration requirements that address whether an employer is an adviser by reason of advising its own employee benefit plans. It may be necessary for the plan sponsor community to make its voice heard to the SEC on this point.

3. "Volcker Rule" provisions:

■ Communicate with bank trustees of private funds the plan invests in or is considering investing in. Discuss the application of the Volcker Rule to the bank's business related to plan investors and its approach to addressing the new requirements.

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[37] Act, § 619, adding BHCA § 13(h)(1).

[38] Act, § 619, adding BHCA § 13(d)(1)(G).

[39] E.g., arguably the reference to bona fide fiduciary customers requires a fiduciary relationship outside the investment fund.

GROOM LAW GROUP

ERISA For Securities Professionals

By

Richard K. Matta*

The following is an overview of how the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), applies to securities professionals such as registered investment advisers ("RIAs"), registered broker-dealers and individual registered representatives and financial planners who advise, manage, or trade for investment portfolios of private employee benefit plans and individual retirement accounts ("IRAs"). As noted below, ERISA does not apply to governmental plans, which are governed by state law; however, many of the ERISA concepts are followed by governmental plans.

The principal focus of this article is on investments in securities registered under the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act"), and securities of investment companies registered under the Investment Company Act of 1940 (the "ICA"). Many of these principles also will apply directly to interests in unregistered vehicles, as well as to other investments offered by banks, insurance companies, commodity trading advisers and real estate advisers, though there may be some variation.

Key changes resulting from the Pension Protection Act of 2006 ("PPA") are expressly noted.

Summary

The law broadly known as ERISA comprises a number of provisions of the Internal Revenue Code (the "Code"), the Federal labor laws, and other Federal laws. Except for the prohibited transaction rules of the Code, which fall mainly under the jurisdiction of the Department of Labor ("DOL") and closely parallel the prohibitions in the labor provisions of ERISA, the Code rules mainly deal with the tax-qualification of plans and are beyond the scope of this discussion. The provisions of ERISA of greatest concern to securities professionals are the labor-law fiduciary requirements contained in Title I of ERISA. These can be broadly divided into five major categories:

- Coverage and definitions
- Reporting and disclosure
- General fiduciary obligations, including co-fiduciary principles
- Prohibited transactions
- Enforcement, including bonding requirements

Each of these areas is discussed in detail below.

<u>Coverage and Definitions</u>

A securities professional will be subject to ERISA only if, and only to the extent, that he or she is dealing with ERISA plan assets. For this purpose, there must first be a "plan"; the plan must be subject to ERISA; and the assets in question must be "plan assets" of that plan. Once this determination is made, the next question usually is whether the professional's relationship to the plan is as an ERISA "fiduciary" or merely as a non-fiduciary service provider.

What Is an ERISA Plan?

The requirements of ERISA Title I only apply to "employee benefit plans," or simply "plans," which are further subdivided into "pension plans" and "welfare plans." At minimum, every ERISA plan requires:

- ***A "plan."*** Certain *ad hoc* arrangements covering one or two individual employees usually are not plans.
- ***A plan sponsor.*** Specifically, there must be more than *de minimis* involvement of an employer or union sponsor.
- ***Employees.*** A plan must cover employees; accordingly, a plan covering *only* self-employed individuals and their spouses is not subject to ERISA.
- ***Employee benefits.*** Although not normally at issue, some common payroll practices and employee "perks" are not employee benefits for ERISA purposes.

IRAs and Keoghs. For lack of an employer and/or employees, most individually marketed IRAs and many so-called "Keogh" plans (including director plans) ***are not*** ERISA plans. One major point of confusion, however, relates to the fact that IRAs and Keoghs ***are*** benefit plans under the Internal Revenue Code, **<u>including the prohibited transaction rules</u>**; accordingly, much of the following discussion is also relevant to IRAs and Keoghs.

403(b) plans. Traditionally, 403(b) tax-sheltered annuities were sold directly to employees under the fiction of little or no employer involvement, and thus were not subject to ERISA. However – particularly in light of recent IRS rules requiring the adoption of a written plan document – more and more 403(b) plans are now subject to ERISA.

For securities professionals, the foregoing is mainly an academic exercise; the types of arrangements most frequently encountered, such as traditional tax-qualified pension and profit-sharing plans (including 401(k) plans) are almost always ERISA plans when sponsored by private, non-governmental employers.

What Plans Does ERISA Govern?

Not all plans are subject to ERISA (and some are partially exempt). Most private employer plans are subject to ERISA (both for-profit and not-for-profit). Governmental plans generally are exempt, although many are subject to similar state-law requirements. For this reason, many fiduciaries apply their ERISA compliance procedures to governmental plans. Church plans also generally are exempt, but often can elect ERISA coverage. Plans maintained outside the U.S. are not subject to ERISA, *if* they primarily cover nonresident aliens.

What Are ERISA "Plan Assets"?

Every security or other asset owned *directly* by an employee benefit plan or an IRA is a "plan asset" subject to ERISA (and/or the Code). The more difficult question is whether an asset owned *indirectly* is also treated as a plan asset.

In theory, the concept of "plan assets" is simple – an entity that is not itself a "plan" subject to ERISA will be treated as holding plan assets if its primary purpose is to invest retirement plan assets. In effect, ERISA "looks through" the vehicle, and the persons who manage its assets will be treated as directly managing the assets of the plan. In addition, any business transactions of the entity must be analyzed in light of ERISA's fiduciary and prohibited transaction rules.

In practice, these rules are complex and sometimes counterintuitive. ERISA itself defines "plan assets" only in the negative, exempting registered investment companies and insurance company guaranteed benefit policies. DOL regulations attempt to provide greater guidance. First, they clarify that the concept of "plan assets" only applies to equity investments; there is no look-through when a plan invests in any *true* debt instrument. Second, the regulations start with the proposition that you look through *every* equity investment unless an express exception applies.

The principal exceptions in the regulations (in addition to registered investment companies and insurance company guaranteed benefit contracts) are:

- ***"Publicly offered securities."*** Such securities must be 1) freely transferable, 2) widely held (more than 100 holders unrelated to management and to each other), and 3) registered under the 1934 Act (or scheduled to be registered subsequent to an IPO), *i.e.*, most public companies.
- ***"De minimis" holdings.*** Any investment in an entity that does not have "significant" (25% or more) benefit plan investor participation in any class of equity interests. This is the exception typically used by hedge funds. What constitutes a "class" of equity interests is not clear, and remains the subject of much debate.

  PPA note*:* Before the Pension Protection Act of 2006, the 25% test was applied by treating every retirement plan (and every entity holding plan assets) as a "benefit plan investor," whether or not such plan was otherwise subject to ERISA (*i.e.*, including governmental and foreign plans). However, the PPA modified this rule so that ***only*** plans subject to ERISA or the Code (including IRAs) are counted toward the 25% test. Moreover, when an entity holding plan assets makes a "downstream" investment in another entity, it is treated as holding plan assets only "to the extent" that it has benefit plan investors (*e.g.*, if it is owned 30% by benefit plan investors, 30% of its assets are treated as plan assets, not 100%).

- ***"Operating companies."*** Investments in companies that develop or market goods and services other than the investment of capital, plus certain "hybrid" entities known as "venture capital operating companies" and "real estate operating companies."

Notwithstanding the foregoing, certain entities *always* are deemed to hold plan assets unless registered as investment companies or publicly traded. These include group trusts (*e.g.*, bank collective investment funds), most insurance company separate accounts, and any entity owned 100% by a single plan or group of related plans (other than an ESOP).

Accordingly, for example, if a plan invests in a mutual fund, the RIA that advises the fund as to the investment of its assets will not become an ERISA fiduciary, but any RIA that advises the plan as to its investment *in* the mutual fund will be a fiduciary. However, if the plan invests in an unregistered hedge fund, *both* the RIA that advises the plan and the RIA that advises the hedge fund may be fiduciaries.

Ordinarily, interests in securitized vehicles (*e.g.*, mortgage pools) that are treated as debt for tax purposes should constitute debt for ERISA purposes. However, the mere characterization of an interest as debt is not sufficient; it must be judged on its merits, including its credit rating. It should also be noted that holding debt of a "party in interest" raises certain prohibited transaction concerns. See below.

Who Is a "Fiduciary" Under ERISA?

ERISA defines three categories of fiduciaries: 1) those who *exercise* authority or control over the management or disposition of plan assets; 2) those who provide investment advice for a fee with respect to plan assets, or *have* authority or responsibility to do so; and 3) those who *have* discretionary responsibility or authority to administer a plan. The Code contains identical definitions for IRAs, and they interpreted consistent with the ERISA rules.

RIAs and other money managers typically would fall into one of the first two categories (management of plan assets or investment advice). Broker-dealers acting only as such generally are not fiduciaries; however, certain traditional broker-dealer activities can, in some circumstances, cross the line into investment advice, as discussed below. Financial institutions acting as recordkeepers and third-party administrators typically do not have discretionary responsibility or authority to administer a plan and are ***not*** fiduciaries (this role usually remains with the employer); however, having authority to hire or fire other plan service providers may cross the line.

The vast majority of questions regarding the fiduciary status of a financial professional revolve around the concept of "investment advice." The term has a different meaning under ERISA than under the Investment Advisers Act, as well as different implications:

What is investment advice under ERISA? The definition of investment advice under ERISA is **narrower** than under the Advisers Act. For investment recommendations to constitute ERISA investment advice, generally those recommendations must:

- be rendered on a "regular basis" – this affords something of a "one-bite" exception;
- be rendered for a fee, direct or indirect;[1]
- be provided pursuant to an agreement, arrangement, or understanding (which may be implied by course of dealing and reliance);
- be individualized to the plan's particular needs; and
- serve as *a* (not *the*) primary basis for another plan fiduciary's investment decisions.

DOL's "employee education" Interpretive Bulletin (regulation), discussed below, though not directly applicable to relations between an investment adviser and a plan, provides additional guidance as to what constitutes "individualized" investment advice.

Securities professionals should note that once the line is crossed under ERISA, for purposes of fiduciary liability there is ***no distinction*** between "discretionary" and "non-discretionary" investment advice (provided, of course, that the non-discretionary advice is followed by the client).

The law remains unresolved as to whether the "pension consultant" role of recommending *managers* constitutes investment advice under ERISA. In this respect, it can be argued that the recommendation of an investment fiduciary is neither a recommendation regarding "the value of securities or other property," nor a recommendation regarding "investing, purchasing, or selling securities or other property" under the ERISA regulations. However, there is authority for the proposition that DOL reads the statute more broadly. For this reason, pension consultants often stop short of recommending specific managers and merely offer lists of qualified managers.

When does one cross the line between "education" and "advice"? In 1996 DOL issued an interpretive bulletin ("IB 96-1") indicating what level of investment "education" services may be provided to 401(k) plan participants and beneficiaries without crossing the line into fiduciary investment advice. IB 96-1 describes four categories of information that may be provided on a non-fiduciary basis:

- **Plan information.** This is basically descriptive information.
- **General financial and investment information.** This is general advice regarding investment "concepts," terminology, risk assessment, etc.

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[1] This is one part of the definition that financial professionals always seize upon. However, DOL has interpreted the fee requirement very broadly. A financial professional should assume that if he or she is acting under a profit motive, there will be a fee *somewhere*.

- **Asset allocation models.** "Generic" models may be provided along with generic information regarding the means by which participants may assess which model to use. The models may relate to specific plan-designated investment options if certain disclosures are made.

- **Interactive investment materials.** This extends the asset allocation concept through the use of "generic" questionnaires, computer programs, and other interactive means to allow participants to assess their retirement needs, goals, risk tolerance, etc. and to apply those assessments to available investment options.

Although binding on DOL, whether these guidelines would prevent a plan participant or beneficiary from challenging the fiduciary nature of an asset allocation program is unclear.

Although IB 96-1, on its face, applies only to participant-directed ERISA plans, it should also apply equally to self-directed IRAs. Moreover, although it only purports to cover education provided by an employer to employees, the principles that it sets out should apply equally in any other context, such as when an adviser helps a plan sponsor determine an appropriate asset allocation.

When do broker-dealer activities become investment advice? The original investment advice regulations under ERISA were designed to ensure that traditional investment "recommendations" broker-dealers would not, by themselves, be considered investment advice for ERISA purposes. In addition, the regulations contain a "safe harbor" under which a broker-dealer may be given a limited range of discretion (as to time frame, price range, etc.) within which to execute a trade without becoming a fiduciary. For these reasons, much of the discussion that follows relates only to fiduciary RIAs.

However, particularly in the case of smaller plans that come to rely upon the advice of their brokers as a primary source of information on which to make investment decisions, in a number of individual cases DOL and the courts have found that broker-dealers have crossed the line and become ERISA fiduciaries.

In addition, the growing practice of providing "transition brokerage" or "transition management" services may cause transition brokers to fall outside of the safe harbor for execution to the extent that they are given a greater range of discretion than is permitted under the regulations. In order to fit within the safe harbor, trading instructions provided to a broker must be given by a fiduciary independent of the broker and must specify ***all*** of the following:

- Identity of the specific security(ies) to be bought or sold.

- Price range within which the security may be bought or sold.

- A time span for executing the transaction, not to exceed 5 business days.

- The number of shares (or dollar value) to be bought or sold.

PPA note: The PPA added a statutory exemption for the provision of investment advice to participants. This exemption is discussed later in this article.

Who is an "investment manager" under ERISA (and why does it matter)? An RIA who has actual authority to acquire, manage, or dispose of plan assets can be appointed as an "investment manager" for ERISA purposes. A bank or insurance company may also be an investment manager. An investment manager must acknowledge its fiduciary status in writing.

The appointment of an investment manager under ERISA ***is not mandatory*** and is solely for the benefit of the appointing fiduciary. A plan fiduciary who properly appoints an investment manager (and any trustee who follows the manager's directions) generally will not be liable for investment decisions of the investment manager. The appointing fiduciary must be a "named fiduciary" under the plan, and remains liable for prudently selecting the manager and monitoring its performance.

Note: Investment manager status affords no legal benefit for the manager itself.

DOL requires that a state-registered adviser that wishes to be appointed as an investment manager must file a copy of its registration electronically with DOL, through the Investment Adviser Registration Depository (IARD).

"Taft-Hartley" – Where Does it Fit in?

There is often a great deal of confusion as to whether so-called "Taft-Hartley plans" are subject to ERISA. In fact, *they are subject to ERISA in the same manner as any other benefit plan*. The 1947 Labor-Management Relations Act, informally known as the Taft-Hartley Act, is a law governing labor relations, not benefit plans as such. It acts as an overlay to the structuring of certain collectively bargained plans, *in addition to* ERISA.

In general, for securities professionals, the key points to note about Taft-Hartley plans or funds are (1) they subject to collective bargaining, usually between a single union and several contributing employers in a single trade or business (hence the alternative term "multiemployer plan"); and (2) they are trusteed by an equal number of representatives of the union (union trustees) and the employers (management trustees).

This structure has certain practical implications. All costs must be paid from "plan assets" as there is no separate pool of employer assets to draw upon; one result is that contract indemnities are more limited and often not available. Individual trustees are typically not investment professionals and tend to rely to a greater degree on pension consultants as well as investment managers to insulate them from fiduciary liability. The trust is a committee that must act by majority vote rather than employer fiat. (Note, in particular, that even though the union and management appoint equal numbers of trustees, the management trustees represent multiple companies and tend to have less continuity, so the union trustees often wield disproportionate influence in the decision-making process.)

Reporting and Disclosure

ERISA imposes a number of **reporting** obligations (to DOL and in some cases to the PBGC or IRS) and **disclosure** obligations (to plan participants) on plan fiduciaries. These requirements were substantially modified by the PPA and vary depending on the type of plan (defined benefit, self-directed defined contribution, fiduciary-directed defined contribution). Disclosure requirements may include, among other things, summary plan descriptions ("SPDs"), annual funding notices, periodic benefits statements, and summary annual reports. The administrator of an ERISA plan also must file an annual report with DOL on a 5500-series form. Provided certain requirements are met, disclosures to participants under ERISA may now be made electronically.

With limited exceptions, the basic reporting and disclosure requirements of ERISA will not apply *directly* to plan service providers such as an RIA serving as an investment advisory or investment management fiduciary. The primary reporting and disclosure obligations of securities professionals are those imposed by the securities laws. One exception is that a person managing plan assets will be obligated to provide *to the plan administrator* certain financial information necessary for the filing of the plan's annual reports, and to cooperate as reasonably necessary in any required independent annual plan audit.

Notwithstanding the foregoing, in many cases the service provider may be required *by contract* to fulfill reporting and disclosure obligations otherwise imposed on the plan sponsor or other plan fiduciary who has retained the service provider. Reporting and disclosure obligations commonly borne by financial institutions include the following:

Form 5500 filing by "DFEs"

In some cases, in lieu of assisting directly in the preparation of each plan's annual report, a financial institution advising a separate (non-registered) commingled investment fund holding "plan assets" may *elect* to prepare a single entity-level annual report as a "direct filing entity" or "DFE" pursuant to DOL regulations. These regulations provide that the fund manager *may*, within prescribed time periods, file a single audited financial report for the entity with DOL (based on Form 5500). If it does so, the administrator of each investing plan need only report the value of the plan's interest in the entity on the plan's own annual report; otherwise the plan must "look through" the fund and report its proportionate interest in each of the fund's portfolio holdings. Accordingly, this method of compliance is simpler for all parties and often is mandated in investment contracts involving unregistered investment vehicles.

ERISA Section 404(c) Disclosures

A participant-directed plan that is structured to benefit from the fiduciary protections afforded by ERISA section 404(c) must comply with certain additional disclosure obligations. Typically, plan sponsors look to financial institutions to provide some or all of these disclosures. The specific section 404(c) disclosure requirements are discussed in more detail below under "GENERAL FIDUCIARY OBLIGATIONS - ERISA Section 404(c) Relief from Fiduciary Liability."

General Fiduciary Obligations

ERISA imposes certain general obligations on plans and their fiduciaries (generally, these rules do not apply to IRAs). Even a non-fiduciary service provider should keep in mind that these rules will impact its activities. Briefly, ERISA's fiduciary obligations (other than the prohibited transaction rules, which are discussed separately) include:

Exclusive Purpose/Exclusive Benefit Rule

This is the duty of undivided loyalty to the plan, *i.e.*, a fiduciary must discharge its duties *solely* in the interest of the plan and its participants and beneficiaries, for the *exclusive* purpose of providing plan benefits and defraying reasonable plan expenses. However, leaving aside the additional protections of ERISA's prohibited transaction rules (discussed below), which often are considered extensions of the exclusive benefit rule to certain specified fiduciary actions, "exclusive" is read to mean "primary," so that this rule is not necessarily violated if another party derives a truly *incidental* benefit from a plan transaction.

Court cases have made clear that under this rule, fiduciaries have a duty not to mislead plan participants when discussing plan-related matters; some courts have begun to expand this duty into an obligation not to mislead by omission or even to impose an affirmative duty to disclose material information. What if this disclosure obligation conflicts with another duty, such as the insider trading rules? In the *Enron* case, DOL argued, and the court agreed, that there is not necessarily a conflict; insider trading rules are not violated by, and indeed encourage, public disclosure. The result can be a dilemma for corporate insiders who have information that they are not yet ready to release to the public. However, in a 2004 "Field Assistance Bulletin" for its field enforcement staff, DOL did provide some additional guidance to assist directed trustees and other fiduciaries as to what actions they may be obligated to take if anyone within the organization obtains material non-public information regarding a plan sponsor.

Prudence Requirement

A fiduciary must act with the care, skill, prudence, and diligence under the circumstances then prevailing that a reasonably prudent person acting in a like capacity *and familiar with such matters* would use in the conduct of an enterprise *of like character and with like aims*. The highlighted terms distinguish ERISA's prudence rule, often described as the "prudent expert" standard, from traditional common law "good faith" prudence standards (though in most states the common law standard has been replaced by the Uniform Prudent Investor Act, which follows ERISA's approach).

The prudent expert standard means, among other things, that the level of care imposed on an RIA may vary with the complexity of the investments involved. A 1996 letter from DOL to the Comptroller of the Currency, regarding plan fiduciaries' obligations in connection with investments in derivatives, highlights this point.

Note that, in theory at least, DOL has embraced modern portfolio theory in applying the fiduciary standards; in practice, however, DOL's enthusiasm sometimes is not so clear.

Moreover, some professionals have questioned whether modern portfolio theory has been properly applied in the retirement plan context, particularly when it comes to "frozen" plans, *i.e.*, whether "asset based" investing that starts with a 60-40 equity-debt presumption, and that looks principally at the plan's assets and risk tolerance to vary the mix, has been so overemphasized that plan liabilities and funding have been overlooked. Thus, the growing interest in liability-driven investment (LDI) and commitment-driven investment (CDI) strategies.

Duty to diversify investments

ERISA requires that a fiduciary must diversify a plan's investments so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. For example, the expense of greatly diversifying a small portfolio may not justify the additional protection derived (although there may be other ways of achieving both ends, such as commingling the plan's assets with those of other investors). To the extent that an investment manager is responsible only for a portion of a plan's total assets, its obligation to diversify its own portfolio should be clearly spelled out in its investment management agreement; generally, however, it would remain responsible for diversifying within its range of discretion (*e.g.*, a small cap manager would retain responsibility for maintaining a diversified small cap portfolio).

Generally, the duty to diversify does not extend to holdings of employer stock in a defined contribution plan. To the extent that ERISA otherwise permits, and to some extent even encourages, investment in employer securities through various prohibited-transaction exemptions (discussed in more detail below), it also contains an explicit exception to the general fiduciary duty to diversify so long as the investment is otherwise prudent, in the interests of the plan and its participants, and consistent with the plan's documents.

Compliance with Plan Documents

Plan fiduciaries are required to act in accordance with the documents governing a plan *to the extent not inconsistent with the terms of ERISA*. For example, if a plan's trust document prohibits certain types of investments, an investment manager who invests in such assets may be in violation of ERISA even if such investments do not violate its investment management agreement. It should be noted that DOL has used the qualifying language in enforcement actions (for example, in the proxy voting context) to challenge fiduciaries who "passively" adhere to plan terms when it may not otherwise be prudent to do so. In the face of a potential conflict between the terms of a plan and the terms of ERISA, rather than decide which course is correct a fiduciary may wish to consider amending the plan.

In the past, RIAs and other service providers have often tried to address the issue of complying with plan documents by obtaining representations and warranties from the fiduciary who hires them on behalf of the plan (*i.e.*, to the effect that the investment management agreement is consistent in all respects with the terms of the plan). However, DOL has indicated that a fiduciary may not be able to rely on such representations, but must obtain and review applicable plan and trust documents.

Trust Requirement

ERISA plan assets must be held in trust, with certain limited exceptions (*e.g.*, assets held by insurance companies). These rules, however, do not prohibit 1) the holding of securities in nominee or street name with a custodial bank, insurance company, registered broker-dealer, or clearing agency, provided that a trustee is the ultimate beneficial owner of the securities, or 2) the creation of certain single-owner or commingled investment vehicles (corporation, partnership, LLC, etc.) which hold "plan assets," if interests in the vehicles are held in trust. A trustee must be named in the plan or trust documents or be appointed by a "named fiduciary" and must have exclusive authority or discretion to manage the assets held by it *except to the extent* that such authority is 1) reserved to a non-trustee named fiduciary or 2) properly delegated to an investment manager (but only to the extent that the manager's directions to the trustee do not on their face violate the terms of the plan or the requirements of ERISA).

ERISA does not mandate the use of corporate trustees, and many plans (including most Taft-Hartley plans) have individual trustees. Note, however, that the Code does require that IRA assets must be held by a corporate trustee or custodian.

Indicia of Ownership

In conjunction with the trust requirement, ERISA requires that the "indicia of ownership" of any plan assets be held within the jurisdiction of the U.S. Federal District courts. (What constitutes indicia of ownership of an asset generally will be determined by the securities laws or under state/common law.) However, DOL regulations permit the holding of certain *foreign* securities and *foreign* currency outside the U.S., provided that they are held 1) under the management or control of a qualified fiduciary, ***or*** 2) in the physical possession or control of certain qualifying financial institutions, which fiduciary or custodial institution is a U.S. domestic entity whose principal place of business is in the U.S. Although these requirements are complicated, generally a qualified fiduciary must be a U.S. bank, insurance company, or RIA meeting certain minimum size requirements (in the case of an RIA, $50 million in assets under management and $750,000 equity). A qualifying custodial financial institution must be a U.S. bank, insurance company, or broker-dealer meeting similar requirements, or certain of their foreign agents, provided that certain other requirements are met as to a plan's ability to assert and enforce its ownership rights against the U.S. institution.

In early 2008, DOL issued an advisory opinion to Northern Trust regarding its "Multinational Cross-Border Pooling Products." The opinion addressed the application of the indicia of ownership requirements in the context of "global pooling" products. The arrangements described in the opinion involve multiple layers of ownership, management, custody and sub-custody. A global pooling vehicle would be structured as one of several types, typically under the laws of Ireland or Luxembourg. A pooled vehicle may be required to have a local custodian regulated under the law of the jurisdiction where the vehicle is formed. Northern Trust indicated that this would be either Northern Trust (via a local branch) or a local subsidiary of Northern Trust. Where Northern Trust itself is the local custodian, it will also be designated as the "global custodian." Where an affiliate is the local custodian, it will appoint

Northern Trust as global custodian (in reality, as a subcustodian). In some jurisdictions, Northern Trust may further appoint a local (foreign) entity as its subcustodian. As an interesting note, Northern Trust further indicated that uninvested US dollar-denominated cash balances would be swept into an Irish sweep vehicle established by Northern Trust, notwithstanding the rule that US currency must be held in the US. Northern Trust appears to have taken the position, and DOL appears to have agreed, that the indicia of ownership rules would be satisfied because the pool would be holding a foreign security (its interest in the sweep vehicle), rather than US currency (a fine line, to be sure).

Prohibited Transactions

ERISA's prohibited transaction rules are discussed separately below. However, it should be kept in mind that engaging in or failing to prevent a prohibited transaction may be a fiduciary breach separately actionable by DOL or a co-fiduciary (apart from the express penalties imposed on the prohibited transaction itself).

Co-Fiduciary Obligations

A plan may have multiple fiduciaries with *different* responsibilities, *e.g.*, a fixed income manager and an equity manager are both fiduciaries, but their responsibilities do not overlap. Nonetheless, one ERISA fiduciary may be held liable for a breach of another fiduciary – even if the breach has nothing to do with the first fiduciary's responsibilities – if the first fiduciary 1) knowingly participates in, or knowingly undertakes to conceal, the other fiduciary's act or omission, provided that he or she knows that the other party's act or omission is a fiduciary breach; 2) in committing his or her own fiduciary breach, allows the second fiduciary also to commit a breach; or 3) knows of the second fiduciary's breach, unless he or she makes a reasonable effort, *under the circumstances*, to remedy it. (For example, the foregoing fixed income manager inadvertently discovers that the equity manager has committed a prohibited transaction.)

Like regular fiduciary liability, co-fiduciary liability is joint and several; that is, each fiduciary can be sued for the full amount of any damages to the plan, regardless of comparative liability. The full extent of co-fiduciary liability remains to be tested. What if the co-fiduciary obtains its knowledge while acting in a non-fiduciary capacity? What about information obtained by non-fiduciary affiliates?

Note that the term "co-fiduciary" as defined in ERISA has a different (and arguably exact opposite) meaning than its use in the common vernacular. The term is often used by money managers who agree to accept ***joint*** liability with a plan's in-house fiduciary – typically when recommending 401(k) plan investment options. In that context, the so-called "co-fiduciary" is really a non-discretionary investment adviser and will have direct and primary liability for its fiduciary recommendations.

ERISA Section 404(c) Relief from Fiduciary Liability

General. ERISA section 404(c)(1)(A) provides that if a retirement plan permits participants (or beneficiaries) to exercise control over the investment of the assets in their accounts, and a participant actually does exercise control (as determined by DOL regulations), then:

- The participant will not be deemed an ERISA fiduciary merely as a result of exercising such control; and
- No person who is *otherwise* a fiduciary shall be liable for any loss or breach of ERISA that results from the exercise of control.

> **PPA note:** The PPA amended the foregoing to suspend these protections during a "blackout" period (during which the participant is unable to exercise control) unless the blackout is authorized and implemented consistent with all ERISA requirements.

Although simple in concept, this provision by its terms requires implementing regulations. Under the regulations, to qualify for relief, a plan must meet certain requirements, which may generally be summarized as follows:

- The plan must offer participants a "broad range of investment alternatives" that allow participants the opportunity to materially affect the potential return on the portion of their individual account under their control, construct a portfolio with risk and return characteristics at any point within a range appropriate for the participant; and minimize risk through diversification.
- Participants must be permitted to give investment instructions with a frequency that is appropriate in light of the market volatility of the investment alternatives, but not less frequently than once in any three month period, and the plan must comply with specific additional trading frequency rules.
- Participants must receive or have the opportunity to receive specific information regarding investment alternatives.

Though these obligations generally are imposed on the plan sponsor or other named fiduciary(ies), they often fall on service providers by contract or course of dealing. For example, employers often expect that a financial institution offering investment options or investment advice to participants will undertake to ensure compliance or, at minimum, will be in a position to advise the plan sponsor as to how it may meet its compliance obligation.

Required disclosures. Information regarding investment options that ***automatically*** must be given to all participants includes:

- An explanation that the plan is intended to constitute a section 404(c) plan and a description of the relief afforded to the plan's fiduciaries by that section.
- A description of the investment alternatives available under the plan and a general description of the investment objectives and risk and return characteristics of each alternative.

- If any option involves retaining an RIA to act as investment manager, identification of the RIA.
- An explanation of the mechanics of giving investment instructions.
- A description of any fees imposed with respect to an investment option, *e.g.*, fees imposed directly (such as sales loads, direct management fees, etc.). Fees imposed "inside" a mutual fund are not imposed on plan assets and are indirect for this purpose.
- Information identifying a plan fiduciary (usually the plan sponsor, but may be the RIA) who will provide the additional "on request" disclosures described below.
- In the case of an investment option that is an employer stock fund, certain additional information.
- With respect to any investment option that is registered under the 1933 Act (including mutual funds), a copy of the prospectus *delivered immediately before or immediately following* a participant's initial investment.
- All proxies and voting materials incidental to a participant's investment choice, and information regarding the exercise of voting and similar rights, to the extent that those rights are passed through to participants under the terms of the plan.

In addition to the foregoing automatic disclosures, certain additional disclosures must be made to participants ***upon request***:

- A description of the annual operating expenses of each investment option, including a statement as to the aggregate amount of such expenses expressed as a percentage of net asset value.
- Copies of updated prospectuses, financial statements and reports, etc., to the extent otherwise provided (*i.e.*, under the securities laws) to the plan.
- In the case of investments in (non-registered) vehicles whose assets are ERISA "plan assets," certain additional information regarding the underlying investments of the vehicles.
- Information regarding the value of shares or units in available investment options, including past and current performance information (net of expenses). Generally, it would appear that this information must follow SEC (and NASD) requirements if applicable.
- Information regarding the value of shares or units in the participant's account.

Affirmative directions. A key drawback of section 404(c) is the need to obtain affirmative directions from a participant in order to obtain fiduciary relief. "Negative consent" is not sufficient. However, affirmative directions are often difficult to obtain from some employees, particularly in the context of automatic enrollment or when plan investment options change. Accordingly, the PPA amended section 404(c) to permit the use of deemed or negative consent in two circumstances – when "mapping" from an existing investment option to a substitute investment option, and when the employee's assets are placed into a "default" investment option in the absence of an affirmative investment direction. These special cases are discussed below:

Qualified mapping. Section 404(c)(4), added by the PPA, provides that if there is a "qualified change in investment options" under a plan, and if a participant fails to give affirmative investment directions after appropriate notice, then any assets invested in a changing (generally, discontinued) investment option may be "mapped" into new options with similar risk and return characteristics. If so, the plan's fiduciaries will not be liable for losses that result from the investment of the participant's account balance in the replacement option(s).

Mapping under this provision may be an acceptable option in the context of a simple substitution of similar funds, but generally raises significant questions in the case of more complex plan restructuring transactions. In those cases, plan fiduciaries are more likely to map participant balances into QDIAs.

Qualified default investment alternatives (QDIAs). Section 404(c)(5), also added by the PPA, provides that if a plan meets certain notice requirements, a participant who *fails* to give directions will be treated as exercising control over the assets of his account which are invested by the plan fiduciary in a QDIA in accordance with regulations issued by DOL. DOL issued implementing QDIA regulations in late 2007. In early 2008, DOL followed up with certain technical amendments as well a "Field Assistance Bulletin" ("FAB") that attempted to answer certain frequently asked questions.

Fiduciaries who meet the requirements of the regulation are not liable for losses that result from the investment of the participant's account balance in a QDIA or for investment decisions made by a QDIA investment manager. Nonetheless, like any other investment option, fiduciaries remain responsible for prudently selecting and monitoring the default option (and any investment manager with respect to that option), and may be liable for any losses that result from a failure to do so. Investment managers who manage QDIAs would remain subject to applicable fiduciary standards.

Under the regulations, investments eligible for QDIA status generally include balanced funds, certain life-cycle or target-date funds, and managed accounts meeting various conditions.

Some plan fiduciaries have begun to look at section 404(c)(5) as a means of periodically forcing participants to reevaluate their investment portfolios by requiring them to make new affirmative elections from time to time. Those who fail to do so are moved into a QDIA. Such an arrangement is sometimes described as a "plan reset" transaction.

Application of ERISA's Fiduciary Rules to Specific Securities-Related Issues

Proxy voting and corporate governance. Generally, unless the authority to vote has been expressly (and properly) reserved or delegated to another fiduciary in accordance with ERISA, the fiduciary who is responsible for the management of securities held by a plan also will be responsible for voting those securities. DOL regulations recommend that plan fiduciaries adopt statements of investment policy and proxy voting guidelines and that those fiduciaries expressly require (*i.e.*, in the investment management agreement) that the manager comply with those statements. Investment managers likewise are encouraged to adopt their own guidelines, particularly with respect to pooled investment vehicles whose investors otherwise may have differing priorities. (Generally, investment guidelines are not "plan documents," so that they may be overridden by the management agreement.)

Typically, a broad policy of not voting will not be acceptable, though it may be prudent not to vote in certain specific situations, such as where the cost outweighs any potential benefit. For example, the preamble to DOL regulations suggests that foreign securities may sometimes be costly to vote "due to the variety of regulatory schemes and corporate practices." More generally, voting very small shareholdings may be costly in terms of staff time/research costs.

Economically targeted investments. DOL also has issued various pronouncements with respect to the issue of "economically targeted investments," or "ETIs" and other "social investing" issues, including most recently in 2008 regarding the use of Taft-Hartley plan assets to promote union organizing and collective bargaining campaigns. These transactions, in effect, take into account non-economic "social" investment considerations. DOL's position, which remains controversial, is that it is permissible to take non-economic considerations into account ***only*** if an investment otherwise satisfies all fiduciary considerations and otherwise is expected to provide no less a return than other investments with similar risk and return characteristics.

Employer securities. Even before the *Enron* and *WorldCom* cases, it was obvious that holding employer securities in a plan could raise significant ERISA concerns both for employers as well as financial institutions administering plans. Particularly in the case of a troubled company, a key source of concern has been the conflict between following plan terms that mandate investment in employer securities and general fiduciary duties of loyalty and prudence, which may suggest ignoring those terms. Although the law remains unsettled, to date several courts have suggested that there exists a presumption that it is prudent to follow plan terms; in other words, the burden of proof may be on participants to show otherwise. However, this remains a very complicated and volatile area, and more litigation may be anticipated in light of the current economic downturn.

The acquisition, holding and disposition of employer securities also raises various prohibited transaction considerations, see below.

Late trading and market timing. Generally, many of the issues surrounding the late trading and market timing scandals have been addressed both by plans and by mutual funds and their advisers. If nothing else, these issues served as a wake-up call to plan fiduciaries to ensure that they are adequately performing their due diligence and monitoring functions.

Prohibited Transactions

As an extension of ERISA's fiduciary duties, and in deviation from common-law fiduciary principles, ERISA and the Code incorporate very broad prohibitions against a wide range of activities. These prohibitions extend to a broad group of fiduciary and non-fiduciary parties, and roughly fall into three categories: 1) prohibited transactions between a plan and any "party in interest" ("disqualified person" under the Code), which party need not be a fiduciary; 2) the acquisition or holding by a plan of certain "employer securities" or "employer real property"; and 3) fiduciary conflicts, including "self-dealing," direct conflicts (representing a plan and an "adverse party" in the same transaction), or accepting compensation from a third party dealing with the plan ("kickbacks"). As noted above, these rules also apply to IRAs, with some minor differences.

Particularly for securities professionals, it is important to keep in mind that one overriding principle of ERISA's prohibited transaction rules is that they were designed to avoid subjective determinations of violations, even if that result seems harsh. That is – at least until the PPA added a "service provider" exemption, see below – there were no broad exceptions for transactions that are reasonable, "arm's-length," or based on disclosure and informed consent; however, some or all of these factors may be necessary, but usually not sufficient, steps in complying with certain administrative exemptions.

Typically, two of the three broad categories of prohibited transactions are relevant to securities professionals: 1) transactions between a plan and certain "parties in interest," sometimes regarded as *per se* or "objective" prohibitions because they look only to result; and 2) fiduciary conflicts/self-dealing transactions, which often involve a subjective "intent" of the fiduciary.

Party-in-Interest Transactions

Absent an exemption, ERISA prohibits certain direct or indirect transactions between a plan (including a vehicle holding plan assets) and a party in interest to that plan.

Who is a "party in interest"? Parties in interest with respect to a plan include, among others: 1) all fiduciaries of the plan; 2) any person providing services (fiduciary or non-fiduciary) to the plan; 3) any employer or union whose employees are covered by the plan; and 4) numerous parties affiliated with the foregoing in various direct or indirect ways. For a large plan, not even counting employees, there can be hundreds if not thousands of parties in interest.

What transactions are prohibited? By definition, virtually any direct or indirect transaction between a party in interest and a plan is prohibited in the first instance, including sales, exchanges, or leasing of property; lending of money or other extensions of credit (by a plan or to a plan); furnishing of goods or services; and transfers of assets to or for the benefit of a party in interest.

> **Note:** In general, when a plan holds an equity interest in a vehicle that does not hold "plan assets", it is not a prohibited transaction for the vehicle to engage in a transaction with a person who is a party in interest to the investing plan. However, DOL regulations state that if the plan invests in the vehicle *intending or knowing* that the vehicle will transact business with a party in interest, the investment may be prohibited.

What exceptions apply? Notwithstanding the foregoing, ERISA also recognizes plans' needs to engage in certain otherwise prohibited transactions, and so incorporates various statutory exemptions and provides that DOL also may promulgate administrative exemptions. In this respect, certain statutory exemptions relevant to securities professionals include:

- **Reasonable services.** Perhaps the most important exemption is the one permitting a party in interest to contract with a plan for services "necessary" for the establishment or operation of the plan – ERISA section 408(b)(2). Regulations indicate that a service is necessary if it is "appropriate" and "helpful" to the plan in carrying out its functions. However, the exemption only applies if the arrangement and the compensation are "reasonable." The arrangement is reasonable only if it is terminable by the plan without penalty, upon reasonably short notice "under the circumstances."

  It is important to note that this exemption has been interpreted as ***not*** extending to any fiduciary conflict (the so-called "multiple services" issue). For example, unless another exemption applies, an investment adviser would engage in a *separate* act of "self-dealing" if it caused a plan to retain its affiliated broker-dealer to execute trades for additional compensation, regardless of whether the arrangement is reasonable. Self-dealing is discussed separately below.

  > **Note:** In December, 2007, DOL published proposed revisions to its regulations under section 408(b)(2) to incorporate significant new fee disclosure requirements for ERISA plans. The proposal is discussed in more detail below under "Hot Topics."

- **Blind transactions.** Although not incorporated into the statute *per se*, ERISA's legislative history indicates that a purchase or sale of securities between a plan and a party in interest would not be prohibited if the transaction is an ordinary "blind" transaction on a traditional securities exchange (including OTC) where neither party (nor their broker agents) knows the identity of the other. DOL recently issued an advisory opinion extended this concept to an "alternative trading system" that facilitates block trading (Liquidnet ATS) even though it is possible that the parties' identities "could" become known, provided they take steps to remain anonymous.

  > **PPA note:** the PPA added a new statutory exemption to ERISA that exempts trades carried out on certain electronic communications networks (ECNs),

even if not technically "blind" (and even if the RIA or broker has an ownership interest in the ECN), if certain conditions are satisfied with respect to execution mechanics, valuation, and disclosure and consent.

- **Transactions with service providers.** Not to be confused with the above exemption for the provision of reasonable services to a plan, ERISA section 408(b)(17) – added by the PPA – permits a plan to engage in *other* types of transactions (purchases and sales, loans, leases, etc.) with service providers. It requires that the service provider not have fiduciary authority over the assets in question, and that the plan pay no more than, or receive no less than, "adequate consideration." This is a major development, as the original drafters of ERISA expressly rejected the idea of a broad "arm's-length" exception to the party-in-interest prohibitions.

DOL has also promulgated a number of generic or "class" prohibited transaction exemptions ("PTEs"), which are broadly available to any party in interest who satisfies their conditions. (DOL also issues individual PTEs, applicable only to the identified parties.) Many of these class exemptions apply to party-in-interest transactions involving securities, including:

- **Broker-dealer transactions.** The very first exemption, PTE 75-1, broadly exempts certain principal transactions, underwriting, and extensions of credit by non-fiduciary broker-dealers, as well as certain market-making transactions by parties in interest who may or may not be fiduciaries.

  Generally, the exemption for principal transactions does not apply if the dealer (or its affiliate) is a fiduciary with respect to the assets involved in the transaction. However, there is a specific exception in PTE 75-1 for a broker-dealer who *as a fiduciary* (directly or in conjunction with its affiliates) receives a fee for causing a client plan to invest in unaffiliated mutual funds. Although styled as an exemption for principal transactions, it is clear that it was intended to cover typical mutual fund distribution (dealer) agreements.

  The exemption for underwriting (traditional IPOs) should not be confused with the so-called "underwriters exemptions," which relate to the underwriting of asset-backed investment pools (see below with respect to mortgage pool investment trusts).

- **Certain IPOs.** PTE 80-83 exempts certain purchases of securities in an IPO where the issuer may use the proceeds to reduce or retire an indebtedness to a party in interest.

- **Securities lending.** PTE 2006-16 permits plans to engage in securities lending transactions with counterparties who may be parties in interest. Compared to its predecessor (PTE 81-6), the exemption expands the types of collateral that a plan may accept and enables plans to loan securities to certain foreign banks and broker-dealers. The exemption also clarifies that "fee-for-hold" arrangements, as well as loans structured as repurchase agreements can qualify for relief.

- **Short-term investments.** PTE 81-8 permits a plan to enter into certain short-term investment transactions with parties in interest, including certain: 1) bankers' acceptances; 2) commercial paper; and 3) repurchase agreements (but not reverse repos). Similar individual relief was granted in 1996 to Lehman Brothers in connection with the marketing of "synthetic" or "collateralized" GICs ("guaranteed investment contracts").

- **Mortgage pool investment trusts.** PTE 83-1, as amended several times, grants broad relief for a variety of potential prohibited transactions involving plan purchases of interests in certain securitized residential mortgage pools. Numerous individual "underwriter exemptions" have been granted to almost all financial institutions that participate in the offering of asset-backed investments, and extending this relief to other types of asset-backed pools.

- **QPAM.** Traditionally one of the most important exemptions, PTE 84-14, as amended in 2005, broadly exempts transactions effected by a plan at the direction of a "qualified professional asset manager," or "QPAM." *I.e.*, PTE 84-14 permits a plan to engage in transactions with third parties, without needing to conduct due diligence to determine whether such third parties may be parties in interest to the plan.

  A QPAM must be an independent fiduciary and, if an RIA, must have total client assets under its discretionary management of $85 million and shareholders' or partners' equity of $1 million. The exemption is available with respect to any plan whose assets (combined with those of any affiliated plan) represent no more than 20% of the QPAM's discretionary client assets. The exemption does not cover a party in interest who, at the time of the transaction, has the power to appoint the QPAM as the manager of the plan assets that are involved in the transaction for which relief is sought (subject to an exception for certain smaller investors in a pooled fund).

  With limited exceptions, the PTE does not apply to transactions with persons related to the QPAM or the plan sponsor.

  DOL currently is considering an amendment to the exemption that would generally allow a QPAM to provide management services to its own (in-house) plans if certain conditions are met.

  > **PPA note:** the new statutory exemption for transactions with service providers, discussed above, ultimately may largely replace the QPAM exemption, and DOL already is considering whether QPAM will continue to have any utility in the future.

- **Foreign exchange transactions.** PTE 94-20 permits a bank or broker-dealer, or their affiliates, who may be parties in interest with respect to a plan, to act as principal in a foreign exchange transaction with the plan, provided that the transaction is done at the direction of a fiduciary independent of the bank or broker-dealer. PTE 98-54 similarly covers certain foreign exchange transactions that are pursuant to standing instructions.

> **PPA note:** the PPA added a new and expanded foreign exchange exemption that may largely replace these class exemptions.

- **INHAM.** Because many larger plans manage their assets in-house and cannot rely upon the QPAM PTE, DOL issued PTE 96-23 to permit certain transactions directed by such in-house asset managers ("INHAMS"). Among other things, an INHAM must be a separately incorporated RIA subsidiary of the plan's sponsor, or a nonprofit RIA controlled by the sponsor, with at least $50 million under management. It is available only for larger plans ($250 million in assets). The INHAM must obtain an annual audit; largely because of this audit requirement, it is estimated that only 15 to 20 large plans utilize this exemption.

> **PPA note:** as with QPAM, the new statutory exemption for transactions with service providers ultimately may replace the INHAM exemption.

Note that these exemptions contain various conditions and limitations and do not necessarily exempt fiduciary conflicts, which are separately discussed below.

Fiduciary Conflicts

As noted above, ERISA separately prohibits fiduciaries from engaging in certain transactions that may be viewed as resulting in conflicts of interest. These include 1) dealing with the assets of a plan for the fiduciary's own interest or own account ("self-dealing"); 2) acting on behalf of, or representing (in any capacity), a party in a transaction if that party's interests are adverse to the interests of the plan or its participants and beneficiaries (direct conflict of interest); or 3) receiving any consideration for the fiduciary's personal account, from a third party, in connection with a transaction involving plan assets (a "kickback"). Such violations also may, but need not, separately constitute violations of the party-in-interest prohibitions. (Kickbacks may also result in criminal violations.) Types of transactions that may be prohibited by these rules include:

Performance of additional services/hiring of affiliates. Although a fiduciary is not prohibited from being retained on behalf of a plan to provide one or more services for a negotiated fee, a fiduciary cannot use its authority to hire itself or any affiliate to perform additional services for additional fees ("multiple services"). Conversely, there generally is no prohibited act of self-dealing if 1) neither the fiduciary nor any of its affiliates is exercising fiduciary authority but are acting solely at the direction of another, unaffiliated fiduciary (including the provision of "bundled" services) or 2) the additional services are provided for no additional consideration *other than* reimbursement of direct (out-of-pocket) expenses. Limited exemptions to this prohibition have been granted in connection with:

- **Securities lending services.** PTE 2006-16 permits a fiduciary to receive additional compensation in connection with the provision of securities lending services to a plan, subject to prior authorization and certain other conditions. (This had been previously allowed by PTE 82-63; PTE 2006-16 consolidated PTE 86-1, above, and PTE 82-63).

- **Brokerage services.** PTE 86-128 permits the receipt of fees (brokerage commissions) by a plan fiduciary or its affiliate for "effecting or executing" securities transactions as agent for the plan, but only if trading is not excessive in amount or frequency (*i.e.*, no "churning"). Very old DOL guidance suggests that the exemption may cover mutual fund front-end sales loads, even though such fees technically are paid by the fund rather than directly by the plan; however, more recently DOL argued, and a court agreed, that it does not exempt the receipt of 12b-1 fees. "Effecting or executing" is used in normal securities law sense, and includes ancillary services such as clearance, settlement, custodial, or other functions (but not margin lending). If the fiduciary serves as more than an RIA or directed trustee (*e.g.*, as discretionary trustee, plan administrator, or plan sponsor), the exemption only applies if all profits earned on the trades are disgorged and paid to the plan. See also the discussion of PTE 84-24, below.

  PTE 86-128 also extends to agency cross transactions, but only if the broker-dealer is acting solely as agent for the non-plan counterparty (*i.e.*, is not exercising discretion or rendering investment advice).

  All of the conditions of PTE 86-128 are waived with for IRAs, making it a key exemption for broker-sponsored IRAs.

  Keep in mind that the PTE applies to trades that are executed on the advice or at the discretion of a fiduciary adviser; no exemption is required for trades that are fully directed by the client.

The exception to the above rules permitting reimbursement of a fiduciary for its direct expenses must be applied with caution. An expense is "direct" only if it does not represent overhead and only if it would not have been incurred "but for" the provision of services to the plan. In effect, the expense normally must be traceable to a specific plan, not merely allocable among a number of plans. For example, computer software normally would be considered overhead and/or would be usable for the benefit of more than one client; however, software purchased to implement a unique investment program of a single plan client might satisfy the rules for reimbursement.

Investing plan assets in proprietary mutual funds. To the extent that a plan fiduciary also serves as investment adviser to a registered, open-end investment company, the fiduciary's investment of plan assets in the mutual fund may involve one or more fiduciary conflicts. PTE 77-4 (for client plans) and PTE 77-3 (for the fiduciary's own, in-house, plans) provide relief for such investments provided that certain conditions are satisfied, including disclosure and consent, and taking steps to avoid double fees. Similar relief is granted under PTE 79-13 for in-house plans of closed-end investment companies (but not for *client* plans, which effectively prevents most registered hedge fund managers from relying on these exemptions).

PTE 84-24 also exempts, among other things, a plan's investment in a mutual fund where the fund's adviser or principal underwriter is also a directed trustee, prototype plan sponsor, or other service provider with respect to a plan (but not an investment manager or trustee having discretionary authority or control over the plan assets involved in the transaction, nor the plan sponsor), where an affiliate of the fund's adviser or principal underwriter will receive a sales commission with respect to the transaction. For this purpose, sales commissions generally include 12b-1 distribution fees. The PTE does not explicitly authorize the receipt of fund-level advisory and other fees (in contrast to PTEs 77-3 and 77-4), though it appears to do so implicitly. (Note that PTE 84-24 is not limited to the marketing of proprietary funds, though it is often used for that purpose.)

Investing plan assets in third-party mutual funds. To the extent that a plan fiduciary directs (or recommends) the investment of plan assets into a third-party mutual fund or other investment vehicle from which the fiduciary or any of its affiliates may receive compensation (12b-1, transfer agency, subadministration, referral, custody, etc. fees), retention of such fees would be prohibited. DOL's 1997 "Frost" advisory opinion indicates, however, that such fees may be received if they are fully applied, on a dollar-for-dollar basis, to offset plan-level fees or otherwise are credited back to the plan. (Based on the Frost and "Aetna" letters, a follow-up DOL information letter to the American Bankers Association confirms that a fully directed trustee/fiduciary generally may retain such fees with the knowledge and consent of the plan.) Generally, an RIA or broker-dealer acting only in a non-fiduciary capacity would not be subject to these concerns. However, it is important to bear in mind that if an affiliate is a fiduciary, the activities of the RIA or broker-dealer may be attributed to the affiliate.

As noted in the previous sub-section, PTE 84-24 may cover the receipt of sales loads and 12b-1 fees by a party providing (fiduciary) investment advice with regard to the investment of plan assets into a non-proprietary fund. However, DOL has suggested that the relief afforded by PTE 84-24 would not extend to *separate* charges for the investment advice over and above the sales commissions themselves.

See also the discussion above regarding relief to broker-dealers engaging in principal transactions (PTE 75-1), which covers certain transactions involving the investment of client plan assets in third-party mutual funds, where the fiduciary may receive certain types of revenue sharing payments.

Investing plan assets in collective investment trusts and insurance company pooled separate accounts. Section 408(b)(8) of ERISA is a statutory exemption for the investment of plan assets in certain pooled investment vehicles not registered under the Investment Company Act. It provides that "the prohibitions of section 406" of ERISA shall not apply to any transaction between a plan and a bank-maintained common or collective trust fund or an insurance company pooled separate account, where the transaction involves a sale or purchase of an interest in the fund and the transaction is expressly permitted either directly in plan documents or by an independent fiduciary.

DOL has indicated that the exemption permits a money manager or its affiliate to invest plan assets *on a discretionary basis* into a proprietary collective investment trust or insurance company pooled separate account, and to collect additional fees for managing the trust or account. Unlike PTE 77-4, there is no requirement to waive or offset fees (assuming that the fees at the plan level and the fund level are for separate fiduciary services, *e.g.*, asset allocation and portfolio management).

- DOL has questioned whether the exemption covers non-discretionary advice, though logically it should.
- The authorities are less clear whether the exemption permits a fiduciary to receive compensation when investing in an unaffiliated collective trust, though there is nothing on the face of the exemption to suggest that it does not.

Investing plan assets in other unregistered, affiliated vehicles. RIAs and other fiduciaries often seek to invest client plan assets in various types of unregistered proprietary or affiliated investment funds, such as hedge funds or private equity. Generally, there is **<u>no exemption</u>** available comparable to that afforded by PTE 77-4 for investing in proprietary mutual funds. Accordingly, an RIA ***cannot as an ERISA fiduciary*** cause or recommend that a client plan invest in such unregistered vehicles unless it waives or credits back all additional compensation earned at the fund level.

> **Note:** Bank-maintained collective trusts and insurance company pooled separate accounts sometimes are used as "wrappers" around proprietary alternative investments (*i.e.*, as a form of feeder fund). Under this approach, a management fee is charged at the trust or separate account level (pursuant to ERISA section 408(b)(8), see above) *at least equal to* the fee that is otherwise charged by the alternative investment vehicle. The fees at the vehicle level are then waived or credited back against the trust/separate account fees. In this way, it is sometimes possible *indirectly* to invest in affiliated hedge, private equity or other unregistered vehicles.

Participant investment advice. As a general proposition, there are five ways that which a financial institution and its representatives may provide investment advice to individual plan participants and be compensated for their services without violating ERISA:

- **Non-fiduciary advice.** As noted above, the definition of "investment advice" for ERISA is narrower than for securities law purposes, so it is possible to stay on the "safe" side of the line. Two specific examples are:
  - <u>Employee "education"</u> – under IB 96-1, discussed above, a professional provide certain information, modeling, etc., without crossing the line into individualized advice.
  - <u>IRA rollovers</u> – DOL recently opined that an adviser who is not otherwise a plan fiduciary, who recommends that participant roll over his or her plan account balance to an IRA that invests in the adviser's proprietary products, would not be engaged in the provision of "fiduciary investment advice"

either as it relates to taking the assets out of the plan or investing them via the IRA.

- **"Fee leveling."** As discussed above, to the extent that an adviser does not use its authority as a fiduciary to "cause" the receipt of additional compensation (amount or timing) by the adviser or its affiliates, it does not engage in a prohibited transaction. This is the basis for many so-called "wrap fee" arrangements. In addition, DOL has provided guidance to the effect that if a fiduciary adviser receives compensation from a third party, it does not engage in a prohibited transaction if it applies that compensation – on a dollar-for-dollar basis – to offset fees that the plan otherwise is obligated to pay and/or to pay or reimburse third-party expenses (such as the fees of a third-party recordkeeper).

- **Prohibited transaction exemptions.** Many fiduciaries rely on a combination of various statutory and class exemptions as discussed above, *e.g.*, PTEs 75-1, 77-4, 84-24 and 86-128; ERISA section 408(b)(8).

- **"SunAmerica" Advisory Opinion.** DOL's letter to SunAmerica, Advisory Opinion 2001-09A, is an important step in clarifying application of the prohibited transaction rules to a common form of asset allocation program, where the service provider offers its own funds as a package in partnership with an independent investment adviser or through a computer model, which makes recommendations to plan participants as to how their plan assets should be invested. Importantly, this advice may include recommendations that the participant invest in affiliated mutual funds or other affiliated investments, from which the bundled service provider or its affiliates may earn fees. The key to this opinion is that, although SunAmerica presumably accepted "ownership" of (and liability for) the investment advice provided by a third-party (Ibbotson, in SunAmerica's case), it had no influence over the advice given and could not modify it.

- **New PPA "Investment Advice" exemption.** The PPA added an exemption to the prohibited transaction rules whereby a plan fiduciary may provide investment advice to a participant or beneficiary under an "eligible investment advice arrangement." Such "arrangement" is one requiring that the fiduciary's compensation for providing investment advice not be dependent on the selection of investments by the participant ("level fees") or an arrangement requiring that the investment advice be provided pursuant to a computer model. The computer model must meet certain certification requirements.

  DOL has clarified that – in contrast to the fee-leveling discussed above – the level fee requirement under the statute only applies to the person or entity actually giving the advice, not to affiliates. Thus, for example, a broker and its registered representatives might advise a participant to invest in a mutual fund advised by a separate RIA affiliate of the broker.

  PPA note: See below under "HOT TOPICS" for 2008 developments.

Note re: private wealth management. Securities professionals who are retained directly by plan participants and IRA accountholders to help manage their retirement assets should keep in mind that they may be advising with respect to "plan assets" and thus may be fiduciaries subject to all of ERISA's fiduciary and/or prohibited transaction rules. It is irrelevant that the RIA may not otherwise have any contract directly with the ERISA plan or plan sponsor, so long as the RIA's advice extends to the investment of plan assets.[2]

Relief for specific types of fees and other compensation. DOL has interpreted the fiduciary prohibitions to extend to a fiduciary's receipt of any compensation to the extent that the fiduciary's own actions can affect either the *amount or timing* of such compensation. Accordingly, flat or asset-based fees are normally permissible. Transaction-based fees, such as acquisition or disposition fees, sales commissions and certain performance or incentive fees, including cash flow fees, normally are prohibited. However, there are certain exceptions including:

- **Brokerage commissions**. See above regarding PTE 86-128.
- **Performance fees.** In the case of performance fees payable to securities and commodities (but not real estate) managers for transactions involving generally marketable securities, DOL has issued several advisory opinion letters that approve the use of such fees if certain conditions are satisfied. The specific types of fees approved in these letters involved fees calculated 1) as a percentage of portfolio appreciation; 2) as a base fee plus a percentage of appreciation; and/or 3) in the form of a "fulcrum fee," *i.e.*, a fee that goes up or down as determined by the manager's performance relative to an agreed-upon index. Among the various factors on which DOL based its approval was the sophistication of the clients, the marketability of the securities and availability of market valuations (factors that are often glossed over), fixed performance measurement periods and preestablished valuation dates, inclusion of unrealized losses if unrealized gains were included in the calculation, use of standardized indices for base-plus or fulcrum fee calculations, ability of the plan to terminate the arrangement on reasonably short notice (60 days was noted), and compliance with SEC Rule 205-3. (Note that these letters have not been updated to reflect subsequent SEC revisions to Rule 205-3.) DOL has also granted exemptive relief on a case-by-case basis for certain real estate managers (true market values are difficult to obtain for real estate).

  Securities professionals dealing with alternative investment vehicles, particularly those involving private equity and funds of funds, should keep in mind that many performance fee arrangements deviate significantly from those addressed in DOL's

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[2] RIAs in the wealth management area often take the position that any advice they give relates to the individual or family portfolio holdings as a whole, and are not specific to any IRA, 401(k) or other plan assets, such that it does not constitute "investment advice" for ERISA or Code purposes. However, this argument has yet to be tested, and is often inconsistent with the actual facts.

advisory opinions. General partners of partnerships holding ERISA plan assets who style their performance fees as "carried interests" in order to obtain favorable (capital gains) tax treatment should also consider whether such a position is fundamentally inconsistent with ERISA. (That is, in order to argue for capital gains treatment, the manager must take the position that it has an equity interest in the partnership, which in effect is "leveraged" by the partnership or its investors, rather than a fee interest. Simultaneously, to avoid an ERISA prohibited transaction, the general partner generally must argue that its carried interest is really a fee for performing management services.)

- **Soft Dollars and Directed Brokerage.** Generally, the payment of soft dollars would be prohibited if the services provided by the paying broker benefited the fiduciary manager or any of its affiliates. However, the safe harbor afforded by section 28(e) under the 1934 Act generally preempts ERISA. It provides that a discretionary fiduciary who causes a client (plan) to pay brokerage commissions for effecting a securities transaction, in excess of the commissions another broker would have charged for the same transaction, will not be deemed to have breached its fiduciary duty under any law if the commissions paid are reasonable in relation to the value of the brokerage and research services provided by the broker. Section 28(e) only covers agency transactions, and only the receipt of soft dollars in the form of research services. For other types of services and goods, DOL has indicated that a manager can direct a plan to a specific broker to procure goods and services *for the benefit of the plan* that is paying the commissions (subject, of course, to the manager's overall fiduciary obligations to the plan and the overall reasonableness of the commissions). These exceptions do not relieve plan fiduciaries of their general fiduciary obligation to seek best execution of trades.

Allocation of investment opportunities among client accounts. To the extent that an investment manager represents multiple clients, it may be presented with investment opportunities that are appropriate for more than one client but which cannot be acquired in sufficient quantities to meet all such clients' needs. In order to avoid an assertion of a conflict of interest in allocating such investments among clients, the manager should have in place an allocation procedure that is incorporated by reference into each investment management agreement. ERISA does not dictate any particular procedure, as long as it is applied fairly and consistently so as to avoid favoring one client over another. This could include, for example, allocating investment opportunities pro rata among all similarly situated clients or allocating them to certain clients first based on a rotational basis.

Execution of client trades. Similarly, to avoid potential conflicts, a manager or broker-dealer should have in place procedures for the ordering of securities trades for its clients.

Cross-trading between client accounts. It is not unusual for a manager who manages multiple client accounts to buy securities for certain accounts at the same time it is selling the same securities for another account. "Crossing" the securities between the accounts on a pre-arranged basis may save transaction costs and may have other potential benefits. Nonetheless, if the manager has investment discretion with respect to both accounts, engaging in such cross-trading generally raises an ERISA conflict issue, as the manager is "representing" both parties. (To the extent that the manager is directed as to one side of the transaction, it should not have a conflict or the conflict may be exempted pursuant to PTE 86-128, discussed above.)

Some managers have attempted to avoid the conflict by running simultaneous trades through an unrelated broker. DOL's position is that the use of an unaffiliated broker is insufficient, at least if it is understood that the trades will be matched and are not truly "blind." A few financial institutions have obtained individual exemptions to permit cross-trading, but these exemptions are limited in scope and apply only to the institutions which obtained them.

DOL issued class PTE 2002-12 to permit certain "passive" cross-trading similar to the relief granted in various individual exemptions; it is a key exemption used by large banks performing transition management services. In addition, at DOL's invitation, an industry group representing INHAMs has requested relief for trading between affiliated plans, including trades carried out by outside managers.

> **PPA note:** the PPA added a new statutory exemption – ERISA section 408(b)(19) – to facilitate certain "active" cross trading. Under this exemption, the purchase and sale of a security between a plan and any account managed by the same investment manager is exempt from ERISA's prohibited transaction rules if specified conditions are met. For example, the plan must have at least $100 million in assets and a fiduciary independent of the manager must approve the manager's cross-trading program. In addition, the manager must adopt and provide to clients written cross-trading policies and procedures.

Prohibitions Relating to Employer Securities and Employer Real Property

ERISA also generally prohibits a plan from acquiring and holding securities issued by the employer (even if acquired on the open market in a "blind" transaction), or real property leased to the employer, unless certain conditions are satisfied. To the extent permitted under the terms of the plan, and provided that the general fiduciary requirements are satisfied, a defined benefit pension plan (traditional plan paying fixed retirement benefits) may acquire qualifying employer securities and qualifying employer real property provided that, in the aggregate, such assets do not exceed 10% of the plan's total assets.

Although certain recent legislative attempts have been made to change the requirements, generally the 10% limitation does not extend to "defined contribution" plans, including 401(k) plans, if the plan terms *expressly* authorize such investments. In addition, such plans are relieved of the diversification requirements of ERISA to the extent they invest in such assets. For this purpose, "qualifying employer securities" are stock or marketable debt instruments if certain requirements are met to ensure that such instruments were not issued primarily to be acquired by the plan, and if certain other conditions are met regarding price, etc.

In the case of a participant-directed plan, the regulations under section 404(c) impose various additional requirements on the offering of employer securities to participants in order to utilize the fiduciary relief afforded by that section.

In light of the various considerations surrounding the acquisition and holding of employer securities – and because there is often little financial incentive for financial institutions to deal with employer securities – many securities professionals simply adopt procedures designed to avoid acquisition of any employer securities on behalf of a plan, except through a separate employer stock fund established for that purpose or as otherwise individually agreed upon by the manager and the employer.

Special Considerations for IRAs

As noted, most of the prohibited transaction rules and the exemptions discussed above apply equally to IRAs, although there may be certain differences (*e.g.*, PTE 86-128). However, there are certain rules and exemptions unique to IRAs, some of which are noted below:

- ***Disqualification as a penalty for certain prohibited transactions.*** Where an IRA accountholder "engages in" a prohibited transaction with his or her IRA, the 15% prohibited transaction excise tax does not apply; rather, the IRA is "disqualified" and all of its assets are treated as having been distributed to the accountholder (and thus immediately subject to income tax in the case of a regular IRA). Originally designed to "benefit" IRA accountholders by allowing them to avoid the extra burden of the 15% penalty, this provision now raises serious concerns in the context of very small prohibited transactions that occur within very large (rollover) IRAs.

  There is surprisingly little guidance as to what it means to "engage in" a prohibited transaction with one's own IRA. Many practitioners believe that it may refer to any "self-directed" transaction. However, there is reason to believe that disqualification should apply only where the accountholder is an actual party to a transaction with the IRA (such as buying, selling or leasing assets; borrowing money; or receiving compensation for services). In all other cases, the excise tax should remain the proper penalty.

- ***Brokerage commissions of managed accounts.*** As noted above, PTE 86-128 permits a fiduciary to receive sales commissions for "effecting or executing" securities transactions (*i.e.*, as a discretionary or non-discretionary fiduciary), if various conditions are satisfied. ***All*** of these conditions are waived in the case of IRAs.

- ***Prohibited investments.*** IRAs may not invest in life insurance or certain "collectibles."

- ***Pledging IRA assets – brokerage accounts.*** An IRA accountholder may not pledge his or her IRA assets as security for a loan "outside" the IRA (some practitioners even question whether IRA assets can be pledged to support a loan "inside" the IRA). Brokers should note that most brokerage account agreements contain explicit terms permitting the broker to use assets in any brokerage account maintained by an individual to satisfy margin calls and delivery failures in other accounts of the same individual. However, if one of those accounts is an IRA, such a provision may constitute a prohibited "pledge" of the IRA assets. (Conversely, to the extent such a provision may allow the broker to reach non-IRA assets to settle a debt of the IRA, the accountholder may be engaged in a prohibited extension of credit to his/her IRA.)

- ***"Householding."*** Many financial institutions offer fee discounts and other benefits based on the overall volume of assets a client brings to the table, regardless of the source. This is particularly common in the IRA context where an individual accountholder may have several personal, trust and other "family" accounts. Householding raises potential prohibited transaction considerations to the extent that the accountholder may derive a personal benefit (lower fees in his/her individual accounts) from the investment of IRA assets. Often, the issues can be resolved by ensuring that the benefit runs proportionately across all accounts, but this may not always be feasible. (Giving a greater discount to the IRA may resolve the prohibited transaction issues, but could raise additional tax considerations.) In some cases, the relationship services exemptions discussed in the next bullet point may offer relief as well.

  Note: A recent individual exemption to broadly permitted Fidelity to offer special financial benefits to IRA accountholders and family members, taking into account IRA assets.

- ***Bonuses and relationship services.*** Financial institutions sometimes offer gifts or bonuses for opening an account. Generally, a cash bonus paid directly into the IRA should not raise a prohibited transaction issue (nor, in most cases, a tax issue), though any "giveback" requirement (*e.g.*, if the account is not kept open for some minimum time period) may be problematic. However, anything of value given "outside" the IRA raises a potential prohibited transaction concern. DOL has issued three class exemptions for these types of arrangements.

  - PTE 93-1 (the "toaster" exemption) permits a financial institution to make nominal payments of cash or gifts to an individual for opening or contributing to an IRA.
  - PTE 93-33 permits the receipt of certain reduced or no-cost services from a bank (*e.g.*, free checking).
  - PTE 97-11 provides a similar exemption for free or discounted brokerage services.

<u>ENFORCEMENT</u>

Potential Consequences of Violating ERISA

General equitable and civil remedies. ERISA provides that enforcement actions for fiduciary violations generally can be brought by DOL or by other plan fiduciaries and, in some cases, by plan participants and beneficiaries. Remedies generally include the obligation to restore a plan's losses incurred as a result of a fiduciary breach ("make-whole" relief) and to disgorge any profits made as a result of the breach, as well as any other "equitable or remedial" relief, including injunctive relief, that a court deems necessary and appropriate. In some cases, DOL has obtained injunctive relief to prevent a fiduciary from engaging in further violations (for the purpose of using contempt procedures if further violations occur) or even to prevent a person from acting as an ERISA fiduciary with respect to any plan (which could, for instance, effectively put an RIA out of business). In the event of any monetary settlement or court-ordered monetary relief, DOL will also impose a civil penalty of 20% of the applicable recovery amount.

ERISA's fiduciary liabilities are personal. This means that, in general, individuals who exercise fiduciary powers will ***not*** be insulated from liability by acting through a corporate form, though some protection may exist within the jurisdiction of the 3rd Circuit Court of Appeals (Pennsylvania, New Jersey, Delaware).

ERISA's fiduciary liabilities are also joint and several. Thus, if a trustee acts imprudently on the advice of a non-discretionary investment adviser, *either* may be sued for the *entire* amount of any resulting loss, regardless of comparative fault. Moreover, the majority position of the courts appears to be that the fiduciary who is held liable has no implied right to seek contribution from the second fiduciary. In other words, the foregoing trustee may have no recourse against the investment adviser in the absence of an express indemnity in the adviser's contract; indeed, one or two courts have gone so far as to hold that ERISA preempts even an *express agreement* between fiduciaries for contribution or indemnification.

Criminal penalties. "Willful" breaches of ERISA reporting and disclosure obligations are potentially subject to criminal penalties, increased under the Sarbanes-Oxley Act of 2002 to include imprisonment for up to 10 years and fines of up to $100,000 ($500,000 for non-individuals) per violation. Other non-ERISA federal criminal statutes may also apply to ERISA violations and are sometimes enforced, *e.g.,* in connection with kickbacks from pension funds.

Penalties on prohibited transactions. Violations of the prohibited transaction rules are subject to a two-tiered schedule of excise tax or civil penalties. The initial penalty is 15% of the "amount involved" in the transaction (IRS rules defining the "amount involved" pre-date ERISA and often difficult to apply). In addition, if the transaction is not "corrected" by the parties after notice by the IRS, an additional 100% penalty is imposed. (Correction is not mandatory for non-fiduciary parties, in the sense that they can elect to pay the 100% penalty – for instance, if the cost of correcting is higher than the penalty.) Correction usually involves undoing the transaction (rescission), to the extent possible, or such other action as will put the plan in at least as favorable a position as it would have been in had the transaction not occurred. In the case of a party-in-interest transaction, the primary burden of the penalty will fall on the party in interest that engages in the transaction, although under ERISA (but not the Code) the authorizing fiduciary is also liable. In the case of a prohibited fiduciary conflict, the penalty will fall on the fiduciary. The annual report, Form 5500, requires that any known non-exempt prohibited transactions be reported under penalties of perjury.

> **PPA note:** ERISA section 408(b)(20) provides a limited exemption for certain inadvertent prohibited transactions involving securities or commodities, if corrected within 14 days of "discovery". While styled as new relief, it can be argued that the new provision forecloses a previously common argument that *any* transaction entered on the basis of a mistake in fact (as opposed to a mistake of law), and unwound as soon as such facts were discovered, could be treated as an inadvertent error rather than a prohibited transaction.

As noted above, in some cases the penalty for engaging in a prohibited transaction with an IRA may be tax disqualification.

Claims against non-fiduciary parties. Breaking from common law principles, the courts have held that persons who are not fiduciaries (such as recordkeepers, brokers, custodians) are not subject generally to liability for "aiding and abetting" a fiduciary's breach of its duties. However, at least to the extent that it can be shown that the non-fiduciary has itself breached some ill-defined ERISA "duty" (such as a duty of a party-in-interest not to engage in a prohibited transaction), more recently the courts have found that non-fiduciaries themselves may be subject to claims for "equitable" relief under ERISA, including, for example, disgorgement of fees.

Limitations on Liability and Indemnities

ERISA voids any arrangement in a plan or agreement that purports to relieve a fiduciary of liability for its wrongdoing. This has been interpreted to include any indemnification paid out of plan assets involving an ERISA violation. However, ERISA does not preclude a fiduciary from contracting with another fiduciary or the plan sponsor for indemnification, or from obtaining (or requiring another party to obtain for its benefit) fiduciary insurance to cover its financial losses. The cost of fiduciary insurance may be borne by the plan, so long as the insurer has recourse against the fiduciary in the event a fiduciary breach is found to have occurred.

ERISA's Bonding Requirements

Every ERISA fiduciary and any other person who "handles" employee benefit plan assets must be covered under a fidelity bond, which relates to fraud, theft, embezzlement, etc., and not to breaches of fiduciary duty. Regulated banks and other entities with trust powers under local law are exempted if they have capital of at least $1 million; note however, that an exemption may not be available to a state-chartered trust company acting only as a non-fiduciary custodian. The PPA further exempted broker-dealers who are subject to the bonding requirement of a self-regulatory organization (*e.g.*, FINRA). There is no exemption available for RIAs who are not also banks, insurance companies or broker-dealers.

The amount of the bond must be not less than 10% of the funds handled as of the beginning of the fiscal year, with a minimum of $1,000 and a maximum of $500,000 *per plan*, increased to $1 million for a plan holding employer securities. The cost of bonding may be borne by the plan.

Some plans maintain blanket bonds covering all persons who handle assets of the plan, or purchase riders covering agents. However, some sureties no longer provide coverage that extends to parties other than the purchaser and its affiliated persons. Thus, an RIA generally would have to obtain its own individual coverage covering its employees and agents, naming each client plan as the insured party.

In late November, 2008, DOL issued additional bonding guidance by way of a Field Assistance Bulletin.

ERISA Preemption

ERISA broadly preempts "any" state law that "relates to" an ERISA-governed plan. The preemption provision is limited by a "savings clause," which leaves in place state insurance, banking, and securities laws. The savings clause itself is limited by the so-called "deemer clause," which provides that a state may not circumvent preemption by "deeming" a benefit plan or benefit plan trust to be an insurance company, bank, trust company or investment company or to be engaged in the business of insurance or banking. Generally, these rules mean that a state may not regulate investment activities of plans, but may continue to regulate the activities of securities professionals who market products or services to plans.

The interplay between ERISA's preemption and state laws governing normal commercial activities – such corporate/partnership laws, laws governing contracts, and tax laws – is highly complex and not well settled. Although it is clear that ERISA plans can enter into contracts, under some circumstances ERISA may impact the interpretation or enforcement of contract terms. For instance, if a contract results in a prohibited transaction, a plan may have a right to rescind or void part or all of the contract terms.

ERISA does ***not*** preempt other federal laws, nor does it preempt state laws as they apply to non-ERISA plans such as IRAs.

DOL's Audit and Enforcement Role

DOL has broad audit, subpoena, and enforcement powers and generally may review any books and records of any party that contain information relating to the filing of any return or report required under ERISA. Investigations may be initiated by DOL on its own initiative or at the request of plan fiduciaries. For certain industries, DOL auditors may target specific issues, and auditors from the SEC, the OCC, the Federal Reserve, and other Federal agencies may request information regarding ERISA compliance and refer questionable cases to DOL for further investigation. Audit and enforcement actions generally originate from local and regional DOL offices, but may be coordinated with the National Office staff. Securities professionals who are asked to produce books and records should consult with counsel familiar with such matters; too often, audit targets react improperly to such requests – either by failing to cooperate fully or, at the opposite extreme, by producing far more information than is necessary.

In July 2008, DOL and the SEC entered into a Memorandum of Understanding ("MOU") regarding consultation and sharing of information between the two agencies. Among other things, the SEC granted DOL access to SEC examination information. In theory, the MOU merely formalized arrangements that several DOL field offices already had in place with their SEC counterparts, but the formality also appears to signal greater mutual enforcement efforts.

HOT TOPICS

The employee benefits field has seen an incredible number of changes in recent years. The Pension Protection Act of 1986 (PPA), whose principal focus was pension plan funding, included the most sweeping changes to ERISA's prohibited transaction rules since ERISA was enacted. There have been other significant legislative, regulatory, enforcement and litigation developments. Some of the more significant recent developments affecting RIAs, broker-dealers and other financial service providers to retirement plans are summarized below.

DOL Fee Reporting and Disclosure Initiatives

Reacting to various pressures, in recent years DOL has taken various steps to increase reporting and disclosure of fees and other compensation. The first steps involved the reporting of gratuities to (and by) union members.

In 2007 and 2008, DOL announced three major fee disclosure initiatives. The first involved significant changes to the reporting of payments to service providers on the Form 5500 annual report for ERISA plans (Schedule C). The second involved a proposed revision to the regulations under ERISA's "service provider" regulations under section 408(b)(2), to incorporate new fee disclosure obligations on service providers to plans. The proposed regulations were accompanied by a proposed class exemption. The third prong involved new disclosure regulations with respect to self-directed account plan fees. ***These fee disclosure requirements will have an enormous impact on financial institutions providing services to plans.***

Reporting meals and entertainment/"gratuities". Although not strictly an ERISA issue, the reporting requirements applicable with respect to payments made to union trustees of Taft-Hartley plans became a significant issue in 2005. Generally speaking, for securities professionals, payments commonly associated with business development and client relations activities – such as meals, golf, travel, seminars, etc. – may be reportable on a Form LM-10 which must be filed by the RIA/broker-dealer or other service provider. Conversely, the union official or employee (including his spouse or minor children) who receives the benefit of such payments may be required to report the amounts on a Form LM-30 that he is required to file with DOL.

The statutory basis for Form LM-10 and Form LM-30 reporting is found in the Labor Management Reporting and Disclosure Act of 1959 (the "LMRDA") or Landrum-Griffin Act. In general, the Form LM-30 must be used by a union official or union employee to report anything of value he, his spouse, or his minor children directly or indirectly receive from any employer or business dealing with a union or (pension) trust in which a union is interested. Although these rules have been in existence for decades, only recently has DOL focused on enforcing them.

Reporting does not necessarily mean that such payments are improper or illegal kickbacks (thought they may be under ERISA or other laws), but in and of itself reporting is meant to have a deterrent effect as the information is publicly available on the Internet. However, DOL also began to focus on whether meals and entertainment may constitute prohibited "kickbacks" under ERISA when the recipient is a plan fiduciary (in particular, union trustees).

In 2008, DOL announced that it would be revising its Enforcement Manual to address certain permissible expense items. First, the Manual instructs investigators to "ignore" entertainment provided to plan fiduciaries where the cost of the entertainment is $250 or less per person, per year (informally, DOL staff have indicated that this $250 is a "safe harbor", not a bright line, though it is not clear that this will be reflected in any writing). Second, in the case of educational conferences, investigators are instructed to ignore a plan fiduciary's participation at a conference regardless of cost, where such participation is permitted by the plan's policies and procedures and where the cost of participation otherwise could have been paid by the plan. In all cases, the decision to authorize the plan fiduciary's attendance should be well-documented.

Form 5500 Schedule C changes. In late 2007, DOL made various changes to the ERISA Annual Report (Form 5500) that must be filed by plan administrators. For securities professionals, the most notable changes were to Schedule C, with respect to the reporting of "indirect" service provider compensation (previously, the Schedule covered only direct compensation) beginning in 2009. For this purpose, indirect compensation includes a broad range of fees and expense reimbursements, including third-party payments (revenue sharing, 12b-1 fees, etc.), float, brokerage commissions, soft dollars, and even "non-monetary" compensation such as meals and entertainment. Some relief is granted for "eligible indirect compensation" if certain disclosures are made regarding the nature of the compensation, and when payments are made to a "bundled services" provider who then further allocates such payments among subcontractors and affiliates. The new requirements raised innumerable questions. In July, 2008, DOL attempted to address some of these questions by publishing on its website guidance in the form of 40 questions and answers, or "FAQs" . Nonetheless, many questions remained unanswered.

Proposed section 408(b)(2) fee disclosure regulations. As noted above, the mere provision of services to a plan for a fee can be a prohibited transaction under ERISA. A key provision of ERISA, section 408(b)(2), provides broad relief from the prohibited transaction rules for service contracts or arrangements if:

- the arrangements are reasonable;
- the services are necessary for the establishment or operation of the plan; and
- the plan pays no more than reasonable compensation for the services.

The proposed changes to the regulations would add a number of disclosure requirements in order for a contract or arrangement to qualify as a "reasonable arrangement." DOL has taken the position that it is the responsibility of plan fiduciaries who hire service providers to evaluate the compensation and potential conflicts of interest of those service providers. The disclosure requirements in the proposed regulation thus focus on service provider compensation and conflicts of interest. The disclosure requirements would apply to three categories of service providers:

- fiduciaries (either under ERISA section 3(21) or under the Investment Advisers Act of 1940);
- service providers who provide or may provide banking, consulting, custodial, insurance, investment advisory, investment management, recordkeeping, securities or other investment brokerage or other third-party administration services; and
- service providers who receive or may receive *indirect* compensation or fees in connection with providing accounting, actuarial, appraisal, auditing, legal or valuation services to a plan pursuant to a contract or arrangement.

The proposed regulations require that service arrangements be in writing and impose an affirmative obligation on service providers to disclose certain information, including:

- the services to be provided;
- the compensation or fees received by the service provider with respect to each service; and
- the manner of receipt (*e.g.*, direct or indirect) of compensation or fees.

The proposed regulations define "compensation or fees" as money or any other thing of monetary value. *Gifts, awards, and trips received by a service provider are considered to be compensation for services provided to the plan and must be disclosed.*

Under the proposal, a **bundled service provider** must disclose how it allocates compensation or fees that are either separately charged directly against the plan's investment and reflected in the net value of the investment or that are charged on a transaction basis (such as finder's fees, brokerage commissions, and soft dollars). Compensation under a bundled arrangement that does not fit into these two categories does ***not*** have to be unbundled or allocated among the service providers in the bundle.

The proposed rule also requires disclosures focused on potential conflicts of interest, including:

- whether the service provider will – or will not – be a fiduciary in providing services (a highly significant development in and of itself);
- any participation or interest the service provider may have in plan transactions;
- any material financial, referral or other relationship that creates or may create a conflict of interest for the service provider;
- whether the service provider will be able to affect its own compensation or fees without prior approval of an independent plan fiduciary; and
- any policies or procedures in place to address potential conflicts of interest.

These disclosures would have to be made prior to entering into a contract or arrangement, under a written contract that includes a representation from the service provider that the required information was in fact disclosed before the parties entered into the agreement.

As currently proposed, the new disclosure obligations would ***not*** apply to non-ERISA plans, such as IRAs and HSAs, but this may change.

Proposed prohibited transaction class exemption for hiring fiduciaries. The proposed section 408(b)(2) regulations were accompanied by a proposed exemption that would relieve a plan fiduciary from liability if the fiduciary hires a service provider with a reasonable belief that the arrangement met the disclosure requirements and did not know or have reason to know of the failure to disclose at the time it occurred. After discovering the failure, the fiduciary must request the missing information in writing. The plan fiduciary is also required to determine whether to terminate or continue the arrangement with the service provider. This determination must be made based on the facts and circumstances and consistent with the fiduciary's duties under ERISA. In addition, if the service provider refuses to disclose the requested information or fails to provide the requested information within 90 days, the fiduciary must notify DOL of the service provider's failure to disclose. DOL staff have suggested that this "whistleblower" requirement puts the real "teeth" in the new disclosure rules.

Proposed disclosure requirements for participant-directed individual account plans. In July, 2008, DOL proposed new regulations adding extensive new disclosure rules with respect to plans – such as 401(k) plans – that permit such participants to direct the investment of their account balances. The proposed regulations come in two parts. The first part is styled as a new interpretation of ERISA's fiduciary rules. As such, it would apply to all plans that permit participant directions. Specifically, DOL stated that plan fiduciaries:

> must take steps to ensure that [] participants and beneficiaries, on a regular and periodic basis, are made aware of their rights and responsibilities with respect to the investment of assets held in, or contributed to, their accounts and are provided sufficient information regarding the plan, including plan fees and expenses, and regarding designated investment alternatives available under the plan, including fees and expenses attendant thereto, to make informed decisions with regard to the management of their individual accounts.

The second part would amend the regulations that apply to plans "electing" ERISA section 404(c) status.

Among other things, the proposal would impose new annual disclosure obligations for each "designated investment alternative" under a plan, including 1-year, 5-year and 10-year comparative return information similar in format to what is provided by mutual funds; quarterly disclosure requirements; fee and expense disclosures; and other information regarding specific types of investments. DOL prescribed a specific model chart format for investment performance disclosure. The requirements would not apply to investments available under a brokerage window.

Participant Investment Advice

In August 2008, DOL published proposed regulations and a proposed class exemption that would expand upon the statutory exemption for investment advice to individual plan participants and IRA accountholders. The PTE would expand the relief in three major ways: 1) for IRAs, it would permit in many cases the substitution of "educational" materials in place of computer modeling; 2) it would permit an adviser to provide "individualized" or "off-model" advice after the computer model or educational materials have been provided, and to receive higher compensation as a result (*i.e.*, fee leveling would ***not*** be required, even for the individual employee/agent/rep); and 3) in the case of advisers using fee leveling *instead of* computer modeling/educational materials, it would apply the "fee leveling" requirement only to compensation received by the individual employee, agent or registered representative, rather than at the level of the financial institution (fiduciary adviser). This proposal is highly controversial, and Democrat lawmakers might seek to kill or roll back this broader relief in 2009, and might even seek to reverse the PPA exemption.

Litigation

401(k) plan fees. The last several years have seen significant action in the area of fees typically associated with 401(k) plans, most importantly targeting revenue-sharing arrangements between plans, mutual funds (and other investment providers), and plan service providers such as recordkeepers, trustees and third-party administrators. Class-action lawsuits have been filed against plan sponsors, and their officers and directors attacking investment related fees paid to plan service providers andchallenging the use of more expensive fund options (*e.g.*, actively managed versus index funds). Lawsuits have also been filed against insurance companies providing plan administration and recordkeeping services to plans.

In June 2007, a Federal district court dismissed all claims asserted in a suit involving Deere & Co., one of the many lawsuits filed over allegedly excessive and undisclosed 401(k) fees. Deere is significant in that the court's opinion endorsed many of the legal concepts used to defend challenges to 401(k) fee and revenue sharing arrangements, and some hope it may serve as a check on similar suits. Among other things, the court ruled that "[n]othing in the [ERISA] statute or regulation directly requires such a disclosure" and that the mutual fund prospectuses admittedly given to the plan participants "accurately reflect the expenses paid to the fund manager." The court expressed skepticism that participants would gain any practical benefit by knowing the precise details about how the manager subdivided that total fee among profits, revenue sharing and other expenses. Additionally, the court cited DOL's proposal (above) to amend existing regulations possibly to require further fee disclosures as further proof that such disclosures are not required under current law. Finally, the court ruled that ERISA section 404(c) shielded the defendants from any liability arising from the allegedly excessive fees. Citing the fee disclosures provided by the mutual fund prospectuses, and the plan's brokerage window, the court held that "[t]he only possible conclusion is that to the extent participants incurred excessive expenses, those losses were the result of the participants exercising control over their investments within the meaning of [ERISA section 404(c)'s] safe harbor provision."

Investing "in-House" plans in proprietary mutual funds. Five or six years ago, actions were filed by plan participants against several financial institutions that invested benefit plan assets in the institutions' proprietary funds. Although these actions were limited to the financial institutions' own, in-house plans, in theory the allegations could apply to client plans as well. Several new actions were filed in 2007. Plaintiffs alleged, among other things, that the institutions caused plans to pay excessive fees and used the plan assets to "seed" new funds, thereby breaching their fiduciary duties and committing prohibited transactions.

Investment Valuation

ERISA plans. Plan assets must be valued for various purposes under ERISA, including for annual reporting purposes, to ensure proper valuation of participant accounts under individual account plans, for funding purposes, etc. Specifically for annual reporting on Form 5500, ERISA requires that all plan assets be valued at their "current value", which in turn is defined as fair market value where available; otherwise, fair value determined by a fiduciary in good faith.

These requirements themselves are nothing new, but valuation recently became a hot topic for several reasons, including:

- New FAS 157 and FAS 132 "fair value" reporting requirements for plan sponsors and audited plans.
- Increased plan investment in alternative investments and resistance by fund sponsors to provide market valuations.
- DOL Boston regional office 2008 "Benages letter" asserting that plan fiduciaries may have violated ERISA fiduciary rules by failing to adopt and implement appropriate valuation procedures – may not accurately reflect DOL National Office position.
- Current economic crisis and resulting bailout/TARP.

IRAs. As more and more IRAs invest in alternative investments and other hard-to-value assets, valuation also has become a significant issue, but under the Code rather than ERISA. Under the Code, the (corporate) trustee or custodian of an IRA must report annually the "fair market value" of the IRA on Form 5498. This obligation cannot be delegated to the accountholder or any other person. The penalty for non-compliance is only $50 per account, but in theory a non-bank custodian with a pattern of non-compliance could face revocation of its authority to hold IRA assets, and a pattern of non-compliance by a bank custodian/trustee could be reported to its primary regulator. In addition, if an IRA is required to make annual distributions, failure to establish proper value could result in under-withholding.

Pension "Defeasement"

Over the past several years, as a result of changes in accounting rules, weak investment performance, and competitive issues, there has been a lot of interest in some quarters in finding ways to remove defined benefit plan liabilities from corporations' books without terminating the plan and purchasing annuities. One key proposal (greatly oversimplified here) would have involved transferring "sponsorship" of a frozen, underfunded plan (plus some cash "outside" the plan) to a newly formed corporate subsidiary, then selling the stock of the subsidiary to an entity outside of the seller's controlled group (generally for a nominal sum plus assumption of liabilities). The buyer would be managed by financial professionals and owned or funded by a financial institution or institutional investors. The institution could retain fees for managing the assets and, in theory, good management would permit the investors eventually to recover the "outside" assets in lieu of an otherwise taxable "reversion" of excess plan assets.

In 2008, the Internal Revenue Service issued a Revenue Ruling that effectively would prevent the most likely form of such a transaction, by concluding that the transfer of plan sponsorship *other than* in connection with the transfer of significant business operations, assets or employees, violates the Code's "exclusive benefit" rule because the plan is no longer maintained by an "employer" for the benefit of its "employees".

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