New Pension Bill Passed by House Would Modernize Rules Governing Pension Fund Investment

New York
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On July 28, 2006, the House of Representatives passed H.R. 4, the Pension Protection Act of 2006, by a vote of 279-131 with strong bipartisan support. The Senate may act on the legislation as early as this week, although it is not yet clear that H.R. 4 will become law as passed by the House. The proposed legislation deals with a wide range of issues, including funding of pension plans, the validity of cash balance plans and the investment of the assets of individual retirement accounts ("IRAs"), Keogh and other plans subject to Section 4975 of the Internal Revenue Code of 1986 (the "Code") and plans subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). We refer to ERISA plans, IRAs and Keogh plans below generally as "plans."

This memorandum discusses only the investment provisions of H.R. 4 and not the funding, cash balance and other provisions (which would include a number of other significant changes to the pension regulatory regime). ***We also suggest steps to consider if H.R. 4 becomes law***. A copy of the provisions discussed in this memorandum is attached. This legislation would be generally effective upon adoption, except as noted below.

If adopted, H.R. 4 would make several far-reaching changes to the fiduciary responsibility provisions of ERISA and the related provisions of the Code[1] that would substantially alleviate many of the technical restrictions that plans and institutions entering into transactions with plans previously faced.[2] If adopted, these changes would lead to more

[1] For purposes of this memorandum, references to provisions of Title I of ERISA refer also to corresponding provisions of the Code and references to "parties in interest" under Title I of ERISA refer also to "disqualified persons" under Section 4975 of the Code.

[2] Absent an exemption from the prohibited transaction rules of ERISA and the Code, plans are not permitted to engage in any transaction with a person or entity with which it has certain relationships (a "party in interest"), including a "service provider" or a "fiduciary." A service provider includes any person or entity that provides services to a plan. A fiduciary includes any person who has discretion over the plan's assets and any person who renders investment advice to the plan for a fee if the advice is a primary basis for the plan's investment decision.

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efficient execution of financial transactions and permit plans to engage in many transactions on terms determined by a fiduciary to be prudent.

Executive Summary

- New Service Provider Exemption. A new statutory exemption under H.R. 4 would exempt virtually all transactions between a service provider (including fiduciaries other than fiduciaries with respect to the assets involved in the transaction) and a plan so long as the plan receives "adequate consideration."

- New Plan Asset Definition. H.R. 4 would revise the so-called "25% test" used to determine whether an investment entity (such as a hedge fund) is deemed to hold "plan assets" subject to ERISA and the Code.

- New Exemption for Investment Advice to Plan Participants. H.R. 4 would permit a fiduciary to give investment advice to the participants and beneficiaries of participant-directed plans (such as 401(k) plans and IRAs) and would exempt any purchase, holding and sale of a security or other property that results from such advice, and direct or indirect receipt of compensation by the fiduciary, its affiliates and their employees as a result of such transactions.

- New ECN Exemption. H.R. 4 would permit certain securities transactions to be conducted on electronic communication networks, alternative trading systems and other similar trading systems (collectively, "trading venues") even though (i) the plan's fiduciary may have an interest in the trading venue or the transaction, (ii) a party in interest may be matched with a plan counterparty for a transaction through the trading venue and (iii) the trading venue may interpose itself in the transaction.

- New Cross-Trading Exemption. H.R. 4 would permit a fiduciary to effect securities trades between managed accounts for plans with assets in excess of $100 million under rules similar to those that apply to mutual funds.

- New Bonding Provisions. H.R. 4 would exempt U.S.-regulated broker-dealers from ERISA's bonding requirements and raise the maximum ERISA bond for plans holding employer securities.

- New Block Trading Exemption. H.R. 4 would permit an investment manager to cause a plan to engage in an arm's-length purchase or sale of securities or other property with a party in interest so long as such plan's trade was less than 10% of a block trade being placed on behalf of the manager's client accounts.

- No Excise Tax When Prohibited Transaction Promptly Corrected. H.R. 4 would permit a party in interest to correct an inadvertent prohibited transaction within fourteen days after the date that it was discovered or should have been discovered and thereby avoid any excise tax under Section 4975 of the Code.

- New Foreign Exchange Exemption. H.R. 4 would permit a party in interest to engage in foreign exchange transactions with plans in connection with the purchase, holding or sale of a security or other investment asset on market terms.

- New Rules for Blackout Periods. H.R. 4 would set forth requirements for relief from liability for fiduciaries of participant-directed plans during investment blackouts.

1. Service Provider Exemption.

(a) Background. ERISA and the Code state that persons that provide services to a plan (for example, brokerage, custody and trustee services) and certain of their affiliates are "parties in interest" to the plan. As a result, transactions between the plan and a service provider are prohibited unless effected in accordance with an exemption. That prohibition makes it difficult for plans to engage in routine transactions with financial institutions, including principal transactions in securities and foreign exchange transactions, swaps, forward contracts, repurchase agreements, bank deposits and securities loans. Under current law, such transactions are conducted in accordance with prohibited transaction class exemptions ("PTCEs") issued by the Department of Labor (the "DOL") based on the qualifications of the manager entering into the transaction for the plan (e.g., a "qualified professional asset manager" or "QPAM"), the type of investment vehicle involved (e.g., bank collective trust funds and insurance company general and separate accounts) or the type of transaction (e.g., principal transactions in securities and securities lending). However, many of these exemptions involve detailed and sometimes cumbersome requirements and many smaller ERISA plans, IRAs or Keogh plans often cannot meet their terms. If no statutory or class exemption is available, financial institutions or plan sponsors must seek individual, transaction-specific exemptions from the DOL or refrain from entering into the transaction. The service provider exemption, if adopted, will have a significantly positive effect on the ability of a plan to obtain best execution in the market and to structure investments in a manner that keeps pace with modern developments.

(b) Proposed Change. If adopted, H.R. 4 would provide an exemption for transactions between a plan and a service provider (and persons related to the service provider) if:

- The transaction was not an acquisition or disposition of employer securities or employer real property (note: Section 408(e) of ERISA provides substantially similar relief for such purchases and sales).

- The transaction was not a provision of services, goods[3] or facilities (note: Section 408(b)(2) of ERISA provides substantially similar relief for the provision of necessary services and office space).

- The plan received no less and/or paid no more than "adequate consideration" in the transaction. Adequate consideration would be defined as the price prevailing for a security on an exchange or the offering price for securities traded on a recognized market that is not an exchange. In each case, factors such as transaction size and market liquidity could be taken into account. In circumstances other than the purchase or sale of exchange or market-traded securities, a fiduciary would have to make a good faith determination of fair market value in accordance with regulations issued by the DOL.

- Neither the person transacting with the plan nor any of its affiliates was a fiduciary who had or exercised any discretionary authority or control with respect to the investment of the plan assets involved in the transaction or rendered any investment advice with respect to those assets. This requirement would not preclude a service provider that was a fiduciary with respect to ***other*** assets of the plan from relying on the service provider exemption. However, it might not be available to a fiduciary that engaged in asset allocation activities or manager selection activities with respect to the assets involved in the transaction, even though such fiduciary did not have control or render advice with respect to the particular transaction.

(c) Steps to Consider. Given the breadth of this proposed change, financial institutions may wish to consider, in anticipation of the adoption of the new exemption, a systematic review of their compliance procedures, model agreements, securities offering disclosures and even currently outstanding agreements to determine whether and how the terms and conditions under which trading is conducted or investment products offered could be modified in accordance with the greater flexibility offered by the service provider exemption. For example, if the exemption in H.R. 4 is adopted:

[3] Although the term "goods" is not defined in ERISA, the DOL defined "goods" in PTCE 84-14 (the QPAM exemption) as all things which are movable or which are fixtures used by a plan, but excluded securities, commodities, commodities futures, money, documents, instruments, accounts, chattel paper, contract rights and any other property, tangible or intangible, held primarily for investment.

- Master securities lending, repurchase and ISDA agreements frequently have prohibited transaction representations that might be substantially simplified; such transactions might no longer need to be conducted in accordance with the PTCEs referenced above.

- Trading prohibitions (including those enforced through computer software) and marketing materials might be amended and relaxed in order to allow for the occurrence of previously forbidden transactions, such as principal transactions between plans and foreign institutions or swap transactions with IRAs and smaller ERISA plans that previously had no exemption available to them.

- Restrictions on securities lending imposed by PTCE 81-6, an exemption which was developed for domestic securities lending transactions, would no longer inhibit plans from engaging in transactions more in line with foreign market practices and with foreign financial institutions. For example, PTCE 81-6 requires that the plan receive U.S. dollar collateral and that the loan be terminable by the plan at any time and the securities returned to the plan within a period no longer than five business days.[4]

- Disclosure and compliance procedures restricting the sale of debt issued by a financial institution to plans could be substantially simplified since the proposed service provider exemption would be likely in many cases to displace reliance on the QPAM, in-house asset manager, bank collective trust fund, and insurance company general account and pooled separate account exemptions. It would also allow IRAs and small ERISA plans to purchase such debt without the financial institution needing to obtain an individual exemption from the DOL.

- Requests for individual exemptions from the DOL may no longer be necessary for many transactions if the proposed service provider exemption is adopted, given its breadth. Pending requests could be reviewed to determine whether they could be withdrawn.

However, in contemplating any future reliance on the service provider exemption as proposed, plan fiduciaries and financial institutions should keep in mind the following:

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[4] However, we note that the exception from the unrelated business taxable income rules under Section 512 of the Code for payments with respect to securities loans requires that the plan lender of securities be able to terminate the loan upon notice of not more than five business days.

- It would be essential for financial institutions to continue to request representations from plans that the financial institution was not a fiduciary with respect to the assets involved in the transaction and the transaction was for adequate consideration to ensure that the terms of the service provider exemption were met. (The same caveat would hold true for deemed representations in offering disclosure regarding the terms under which plans may buy.)

- Plan fiduciaries would need to develop procedures for determining and recording whether the "adequate consideration" requirement was met, particularly with respect to transactions not involving securities traded on an exchange or recognized market. To date, the DOL has issued only proposed regulations under Section 3(18) of ERISA which contains a definition of "adequate consideration" nearly identical to the definition in H.R. 4. The proposed regulations set forth a standard of conduct that a fiduciary must meet for it to determine that adequate consideration is being paid. While financial institutions would also need to develop procedures regarding adequate consideration, this determination would ultimately be the responsibility of the plan fiduciary. As a result, the need for financial institutions to receive appropriate representations from the plan fiduciary would be heightened.

- Plan fiduciaries and financial institutions would need to remain cognizant of the difficulty of determining whether a fiduciary relationship might exist with respect to assets involved in a transaction between service providers and investment funds subject to ERISA. The QPAM exemption makes clear that the fund manager in such a case is the deciding fiduciary and provides for a 10% safe harbor with respect to the requirement that the service provider counterparty not have the ability to appoint the QPAM. No such clear distinction has been drawn in the service provider exemption as proposed, with the result that it might not be available to exempt transactions with plans constituting less than 10% of an investment fund subject to ERISA. It is possible, however, that the DOL would issue regulations in the future clarifying this issue.

We note that, independent of the proposed legislation, the DOL recently proposed revisions to the 2007 Form 5500 (due in 2008). If the revisions are adopted, the information required to be provided in Form 5500 regarding compensation paid to service providers by plans or third parties for services to plans will increase significantly in both breadth and detail.

2. <u>Plan Assets</u>.

(a) <u>Background</u>. ERISA's plan asset regulations provide that, unless an exception set forth in the regulations applies, if a plan subject to ERISA or Section 4975 of the Code invests in an equity interest of an entity engaged primarily in the investment of capital, the plan's asset includes not only its equity interest in the investment vehicle but also an undivided beneficial interest in each of the vehicle's assets, thereby subjecting the investment vehicle itself to Title I of ERISA and Section 4975 of the Code. One of the most commonly relied upon exceptions is the so-called "25% test." The regulations provide that if investment in each class of equity of an investment vehicle by "benefit plan investors" is not "significant" (<u>i.e.</u>, is less than 25% of the value of the applicable equity class, excluding equity owned by the manager of the entity's assets and its affiliates (other than benefit plan investors)), then the investing plan's asset will be solely its equity interest and the investment vehicle itself will not be subject to Title I of ERISA or Section 4975 of the Code. "Benefit plan investors" currently include not only plans subject to ERISA and Section 4975 of the Code and investment entities holding plan assets pursuant to the regulations, but also plans ***not*** subject to ERISA or the Section 4975 of the Code, such as U.S. federal, state and local governmental plans and non-U.S. pension plans.

(b) <u>Proposed Change</u>. If adopted, H.R. 4 would effect significant changes to the 25% test.

- The definition of benefit plan investor, and therefore the numerator for purposes of the calculation, would include ***only*** those plans and accounts subject to Title I of ERISA or Section 4975 of the Code (<u>i.e.</u>, ERISA plans, IRAs and Keogh plans) and a portion (as described in the next bullet) of investment entities that are themselves subject to ERISA or Section 4975 of the Code (<u>e.g.</u>, investment funds that do not fall within an exception from the regulations). ***U.S. federal, state and local governmental plans and foreign plans would be excluded from the numerator.***

- If an entity ("Investor Fund") considered a plan asset vehicle (for example, if it is an investment fund with 25% or more of a class of equity held by benefit plan investors) invested in another entity ("Fund"), the portion of the Investor Fund's investment that would be viewed as benefit plan investor money for purposes of Fund's 25% test would be equal to (x) Investor Fund's investment in Fund multiplied by (y) the percentage of Investor Fund's equity held by benefit plan investors. For example, if 30% of Investor Fund's equity were held by benefit plan investors and Investor Fund invested $250 in Fund, then for purposes of Fund's 25% test, it would count only $75 of Investor Fund's investment (30% x $250) as benefit plan investor money. Under

current law, only insurance company general accounts are permitted to pro rate their investments for purposes of the 25% test, and all other plan asset entities' investments are automatically counted as 100% benefit plan investor money.

(c) Steps to Consider. The proposed changes to the definition of "plan assets" would primarily affect investment funds such as hedge funds and funds holding asset-backed securities. Sponsors of such vehicles may wish to consider the following if H.R. 4 is adopted:

- Reviewing and revising disclosures and constraints in governing documents with respect to the sale and resale of equity interests to benefit plan investors, including in existing deals, to the extent possible.
- Reviewing current documentation such as master securities lending, repurchase and ISDA agreements to determine whether representations with respect to plan assets may be modified (in many cases, it would be appropriate to undertake such review in conjunction with reviewing the documentation in light of the proposed service provider exemption).
- Relaxing existing limitations on investment by U.S. governmental plans, foreign plans and foreign insurance companies.
- Reexamining funds offered on foreign exchanges that may have excluded benefit plan investors entirely because of the risk that investment by foreign plans, together with a small interest held by ERISA plans, could cause the fund to exceed the 25% limit.
- Reviewing feeder fund structures designed to maximize ERISA plan investment without forgoing foreign plan investors.
- Rethinking whether it may be a more acceptable risk to offer equity abroad under Regulation S based upon deemed as opposed to written representations, given the fact that foreign plans are no longer included in the numerator (but note that some portion of the investment of an offshore plan asset fund subject to ERISA would still need to be counted).
- If relying on an exception from the plan asset regulations other than the 25% test, such as the venture capital operating company ("VCOC") and real estate operating company ("REOC") exceptions (which require certain types of investments to be made and certain management rights to be acquired), considering the opportunities that the revised 25% test may offer by providing

more flexibility on the investment side with no substantial constraints on the investor side. While the VCOC and REOC tests must be met from the date that the investment entity makes its first long term investment, the 25% test if revised as proposed would provide an exception to the application of ERISA and the Code for transactions entered into after the test is first met. Of course, any decision to change to the 25% test from the VCOC and REOC exceptions would need to be reviewed in light of the entity's investor base as well as its governing documents, disclosures and side letters.

Even if H.R. 4 is adopted as proposed, sponsors of investment vehicles should continue to be conscious of, and cautious with, investments by governmental or foreign plans as such plans may be subject to their own idiosyncratic rules. Some governmental plans may have their own ERISA-like test that would not be affected by these changes. In addition, some governmental plans ask to be treated as plans subject to ERISA and/or Section 4975 of the Code contractually. Any agreement to honor such a request should be designed so as to avoid unintentionally providing that such plans be counted in the numerator as ERISA plans for purposes of the 25% test.

3. Investment Advice.

(a) Background. ERISA and the Code generally prohibit the investment manager of a plan from causing the plan to engage in a transaction with a fiduciary to the plan or with an affiliate of a fiduciary (with the exception of agency executions of securities trades under PTCE 86-128). This prohibition generally prevents IRA holders and plan participants from receiving investment advice from financial institutions that are compensated for such advice through the sale of products or services to the plan.

(b) Proposed Change. If adopted, H.R. 4 would permit certain transactions with, and receipt of fees by, a fiduciary occurring in connection with its provision of investment advice to the participants and beneficiaries of participant-directed plans (such as 401(k) plans and IRAs). Any purchase, holding and sale of a security or other investment property that resulted from such advice, and the direct or indirect receipt of compensation by the fiduciary adviser, its affiliates or their employees in connection with the provision of the advice or the transactions resulting from the advice, would be exempt from the prohibited transaction provisions of ERISA and the Code. The exemption would apply with respect to investment advice provided on or after December 31, 2006. If the exemption is adopted as proposed, its primary conditions would be as follows:

- The sale, acquisition or holding would have to occur solely at the direction of the recipient of the advice (i.e., the participant or beneficiary).

- For advice rendered in connection with plans subject to ERISA, IRAs and Keogh plans, the advice would have to be provided for the same fee (including any commission or other compensation) regardless of the investment option selected (i.e., all fees would have to be leveled).

- For plans subject to ERISA but not IRAs and Keogh plans (unless and until the DOL has determined otherwise in a report due to Congress on the topic no later than December 31, 2007), the advice could also be the product of a computer model that, among other features, utilized objective criteria, was unbiased in favor of investment products of the fiduciary and any affiliated person and was subject to an annual review for compliance by a person independent of the fiduciary.[5]

- The investment advice arrangement would have to be authorized by an independent plan fiduciary.

- The fiduciary adviser would have to be

  (i) a registered investment adviser under the Investment Advisers Act of 1940 (the "Advisers Act") or under state law,

  (ii) the trust department of a U.S. bank or similar financial institution subject to review by federal or state banking authorities,

  (iii) a U.S. broker-dealer registered under the Securities Exchange Act of 1934, as amended (the "Exchange Act"),

  (iv) an insurance company qualified to do business under the laws of a state,

  (v) an affiliate (as defined in Section 2(a)(3) of the Investment Company Act of 1940 (the "Investment Company Act")) of any of (i) though (iv), or

  (vi) an agent, employee or "registered representative" (as defined in Section 3(a)(18) of the Exchange Act) of any of (i) through (v) who satisfied the requirements of applicable insurance, banking, and securities laws relating to the provision of the advice.

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5 This requirement is similar to the facts set forth in DOL Advisory Opinion 2001-09A issued to SunAmerica (December 14, 2001).

- The fiduciary adviser would have to provide the recipient of the advice with notification in writing (which could include notification communicated by electronic means), written in a clear and conspicuous manner calculated to be understood by the average plan participant and provided at the time when the advice is initially given, of the following:

    (i) Any fees or other compensation that would be received by the fiduciary adviser or affiliate in connection with the provision of the advice or transactions resulting from the advice, including compensation provided by any third party,

    (ii) The role of any party with a material affiliation or contractual relationship with the fiduciary adviser in developing the investment advice program or choice of investment options under it,

    (iii) Any material affiliation or contractual relationship of the fiduciary adviser or affiliate in the security or other property,

    (iv) The types of services to be provided by the fiduciary adviser,

    (v) The fact that the fiduciary adviser would be acting as a fiduciary in connection with the provision of the advice, and

    (vi) The right of the recipient to use another adviser who may have no material affiliation with and receive no fees or other compensation in connection with the security or other property.

- The fiduciary adviser would have to provide disclosure in connection with the sale, holding or purchase of the security or other property that complied with all applicable securities laws.

- The compensation received by the fiduciary adviser and any of its affiliates would have to be reasonable. The exemption would not preclude the use of plan assets to pay for reasonable expenses in providing investment advice.

- The terms of the sale, holding or acquisition of the securities or other property would have to be at least as favorable to the plan as an arm's-length transaction would be.

- The fiduciary adviser would have to maintain for not less than 6 years all records necessary for determining compliance with the exemption.

The exemption as proposed would provide that use of a computer model would not preclude the participant or beneficiary from requesting investment advice other than that provided by the model, but only if the request was not solicited by the fiduciary adviser.

The plan sponsor or other fiduciary that selected the fiduciary adviser would have a duty to select the adviser prudently and a continued duty of periodic review of the adviser. However, the person who selected the fiduciary adviser would not be responsible for monitoring the specific advice given, if such advice was provided pursuant to an arrangement the terms of which required compliance with the conditions of the exemption and which included a written acknowledgment by the fiduciary adviser that it would be a fiduciary of the plan with respect to the provision of the advice. Neither the fiduciary adviser nor the fiduciary that selected the adviser would be relieved of its obligation to act prudently and in the best interests of participants in plans subject to ERISA.

In addition, the person who developed the computer model or marketed the investment advice program or computer model would be treated as a fiduciary to the plan under Title I of ERISA by reason of the provision of investment advice and as a fiduciary adviser for the purpose of the proposed exemption.

(c) Steps to Consider. If adopted, this change would permit sweeping changes in the manner in which advice could be given to IRA and Keogh holders and participants in 401(k) plans. Consideration should be given by financial institutions to:

- Developing business opportunities with plan sponsors to advise 401(k) plan participants.

- Reviewing existing restrictions on dealing with IRAs and Keogh plans, particularly in wrap and asset allocation programs, with a view to determining which restrictions would no longer be required and whether the program could be broadly restructured.

- Developing procedures to ensure compliance both with the exemption and with such provisions of ERISA or the Code as continue to apply.

Given that plan participants generally need assistance in investment decision-making to ensure that long term retirement goals are met, plan sponsors would have to give careful consideration to whether it would be desirable to permit participants to retain fiduciary advisers under the circumstances envisaged by the proposed exemption.

4. Electronic Communication Network and Alternative Trading System Relief.

(a) Background. Under current law, the use by plans of an electronic communication network, an alternative trading system or a similar trading system or venue (each, a "trading venue") raised three potential prohibited transaction problems:

- Can a fiduciary with an ownership or other interest in a trading venue direct a plan's trades to the trading venue where its ownership interests or other financial incentives to trade on the trading venue might affect its best judgment?

- Can a party in interest, including a fiduciary with discretion over the plan's transaction, be matched as counterparty in a trade with the plan on the trading venue if the transaction is not "blind"?

- Can the trading venue itself engage in transactions with the plan, such as guaranteeing trades or interposing itself as a principal, without complying with a DOL exemption?

(b) Proposed Change. If adopted, H.R. 4 would provide a broad exemption for transactions in securities or other property conducted on a trading venue subject to regulation or oversight by an applicable federal or foreign regulating entity (the other property and foreign regulatory entities permitted under the exemption would be determined by the DOL by regulation), if:

- The transaction would be conducted on a basis designed to match purchases and sales at the best price available on the trading venue or neither the trading venue nor the parties to the transaction took into account the identities of the parties in the execution of trades.

- The price and compensation with respect to the transaction would not be greater than would be received in an arm's-length transaction with an unrelated party.

- If the fiduciary or party in interest engaging in the transaction had an ownership interest in the trading venue, an independent plan fiduciary would have to authorize the use of the trading venue for transactions and notice would have to be given to such independent fiduciary not less than 30 days before the plan's first transaction carried out in reliance on the exemption was executed through the trading venue.

(c) Steps to Consider.

- Asset managers, plan fiduciaries and financial institutions with ownership interests in trading venues should review any restrictions they have on trading through such trading venues to determine whether they could be relaxed under the proposed exemption.

- Trading venues should review trading rules, constituent documents, membership agreements and subscription agreements to determine whether the terms and conditions of participation could be modified. In particular, trading venues may wish to review formulas for equity allocation and/or other consideration paid by reference to a member's volume of transactions to see if they could be adjusted if H.R. 4 was adopted.

5. Cross Trades.

(a) Background. ERISA prevents a fiduciary from representing a plan and another party whose interests are adverse to the plan in a transaction. Primarily because of this prohibition, the DOL has concluded that trades between two accounts advised by the same adviser are per se prohibited, even if the trade is conducted at market prices and is clearly in the best interests of both clients. The DOL has granted several individual exemptions and a class exemption for cross trades where the plan portfolio involved is index- or model-driven—often referred to as passive cross trades. This position is substantially more restrictive than restrictions under the Advisers Act or under the Investment Company Act.

(b) Proposed Change. If adopted, H.R. 4 would permit an investment manager to cause its advised accounts to trade with each other so long as:

- The transaction was a purchase or sale for no consideration other than cash payment against prompt delivery of a security for which market quotations were readily available.

- The transaction was effected at the independent current market price of the security (within the meaning of Rule 17a-7(b) under the Investment Company Act).

- The plan (or master trust of related plans) involved had assets in excess of $100 million.

- The investment manager established written cross-trading policies and procedures that were fair and equitable to all accounts participating in the

cross-trading program and that included a description of its methods for pricing and allocating between accounts.

- No brokerage commission, fee (except for customary transfer fees previously disclosed), or other remuneration was paid in connection with the transaction by either party to the transaction to the investment manager directing the transaction.

- A fiduciary independent of the investment manager, upon receipt of disclosure including the written policies and procedures of the investment manager, authorized cross trading in advance under a document separate from the investment management agreement.

- The investment manager did not charge different fees or condition the provision of other services based on whether the independent fiduciary had authorized cross trading.

- The investment manager provided a quarterly report to the independent fiduciary with detailed information (including the identity of the counterparty) with respect to each cross trade executed by the investment manager on behalf of the plan during the quarter.

- A person designated by the investment manager annually determined whether the exemption was complied with during the previous year and issued a written report (under penalty of perjury) regarding the results of the compliance review to the independent authorizing fiduciary. The written report would also notify the fiduciary of the plan's right to terminate the investment manager's cross-trading authority at any time.

If adopted, this exemption would apply to both passively and actively managed portfolios.

(c) Steps to Consider.

- Fiduciaries managing passive portfolios who currently rely on an individual or class exemption to engage in cross trading should consider whether it would be easier to engage in such trading under the proposed exemption. The proposed exemption would have far fewer requirements, although it would add an annual audit condition.

- Fiduciaries managing active portfolios should consider whether cross trading actively managed accounts could benefit plan and non-plan clients

alike. However, the proposed exemption would not relieve an adviser of any of its obligations under Section 206(3) of the Advisers Act and Rule 206(3)-2 thereunder or under Rule 17a-7 of the Investment Company Act. Any compliance policies would have to be drafted with each of these requirements in mind.

We note that, as proposed, the exemption would seem to require that each plan invested in a collective investment or pooled fund (other than a master trust of related plans) would need to have assets in excess of $100 million.

6. Bonding.

(a) Background. Section 412 of ERISA requires every person handling plan assets to be bonded (with the specific plan named as the insured) up to a maximum of $500,000. The only exceptions to this bonding requirement are banks and insurance companies regulated by U.S. federal or state authorities. The required bond is plan-specific and the requirement is not satisfied by the normal broker-dealer blanket bond. This requirement can be particularly troublesome for broker-dealers dealing with investment funds containing plan assets since the requirement appears to mandate a separate bond for each plan investing in the fund. It is also difficult to obtain bonds covering foreign entities, including foreign subcustodians.

(b) Proposed Change. If adopted, H.R. 4 would exempt from the bonding requirements any broker-dealer registered under Section 15 of the Exchange Act so long as it was subject to the fidelity bond requirement of an exchange or other self-regulatory organization. H.R. 4 would also raise maximum bond required for plans holding employer securities to $1,000,000. The relief from bonding for broker-dealers would apply to plan years beginning after the date of enactment. The increase in bond amounts for plans holding employer securities would apply to plan years beginning after December 31, 2007.

(c) Steps to Consider.

- Broker-dealers should review their existing ERISA bonds to determine whether they could be cancelled if this provision were adopted in its current form.

- Investment managers or plan sponsors who may have agreed to cover broker-dealers under bonds procured by the manager or plan sponsor may wish to consider whether the broker-dealers could be deleted as bonded entities if the provision were adopted in its current form.

- Financial institutions handling plan assets of plans holding employer securities should consider exploring options for increased coverage.

- As drafted, the proposed legislation would not change the bonding requirement applicable to foreign broker-dealer affiliates or registered investment advisers under the Advisers Act.

7. Block Trades.

(a) Background. Investment managers often aggregate trades for many of their accounts and execute them in a block trade through a single financial institution in order to obtain best execution. However, the manager may be restricted in its ability to trade on behalf of a plan account under its management with certain financial institutions or their affiliates. As a result, the investment manager generally has to "split" trades, segregating transactions for the affected plan accounts from those for its other accounts and executing through different financial institutions. Alternatively, the investment manager must find one financial institution through which it may execute all client trades. This can affect the investment manager's ability to obtain best execution for its accounts.

(b) Proposed Change. If adopted, H.R. 4 would permit a manager to cause a plan to engage in an arm's-length purchase or sale of a security or other property (as determined by the DOL) with a party in interest ***(other than a fiduciary of the plan)*** if the plan's trade were aggregated with at least one other account of the investment manager and the plan (and other plans of the same plan sponsor) did not constitute more than 10% of the block trade. In order to be covered by the exemption, the block trade would have to involve at least 10,000 shares or have a market value of at least $200,000. The proposed exemption would also apply to a trade placed by a plan asset fund subject to ERISA so long as each plan's investment represented less than 10% of the fund. We believe that this change was intended to put separately managed accounts that are aggregated for trading in a position similar to that of bank collective trust funds and insurance company pooled separate accounts under existing statutory exemptions. The proposed exemption, however, by its terms would not cover fiduciaries with the potential result of substantially limiting its actual benefit. It is possible that technical corrections or regulations may clarify whether the exclusion applicable to fiduciaries would apply to all plan fiduciaries or only to those with discretion over, or who provide advice with respect to, the subject transaction.

(c) Steps to Consider. Financial institutions may wish to consider how procedures could be developed to ensure that only securities trades would be executed in accordance with the proposed exemption and that the investment manager would agree to abide by the 10% test and the other conditions of the exemption. Investment managers may wish

to review their allocation and trading policies to see if they could be adjusted if the exemption is adopted.

8. Correction Period.

(a) Background. If a disqualified person (which is the Code's equivalent of ERISA's party in interest) engages in a prohibited transaction, it is subject to substantial excise taxes even if the transaction is inadvertent. The excise tax is 15% of the amount involved for each year or part thereof from the time of the transaction until the time of correction and, if the transaction is not corrected after notice from the Internal Revenue Service, 100% of the amount involved. These taxes are draconian and often impose penalties drastically out of proportion to the harm (if any) to the plan, particularly if the transaction was corrected. Because of this disproportionate penalty and the fact that the plan may have suffered little or no harm, some financial institutions have chosen to err on the side of correcting potentially problematic transactions immediately and being overly aggressive in their positions as to whether an excise tax is due.

(b) Proposed Change. If adopted, H.R. 4 would permit a disqualified person to correct a transaction prohibited by Section 406(a) of ERISA (or corresponding Code provisions) involving securities or commodities within fourteen days after the date that it ***discovered (or reasonably should have discovered)*** such transaction and thereby avoid the imposition of the excise tax. The provision would apply to any transaction that was an acquisition, holding or disposition of any security or commodity other than a transaction between a plan and a plan sponsor involving employer securities or employer real property. This relief would not apply if the disqualified person knew or reasonably should have known that the transaction was prohibited at the time of execution. To correct, the disqualified person would be required to undo the transaction to the extent possible, make good to the plan any losses and restore to the plan any profits made by the disqualified person through the use of the plan's assets. No relief would be provided with respect to any breach of the fiduciary self-dealing rules of Section 406(b) of ERISA (or corresponding Code provisions). The provision, if adopted, would apply to any prohibited transaction that was discovered, or reasonably should have been discovered, after the date of enactment.

(c) Steps to Consider. For securities and commodities transactions, the proposed relief would place a premium on the prompt discovery and correction of prohibited transactions. While the proposed service provider exemption described above may mean that there would be many fewer non-exempt prohibited transactions involving plans and financial institutions, procedures should be established that would enable disqualified persons to identify those that do occur and to correct the transactions in a timely manner.

9. Foreign Exchange Transactions.

(a) Background. Foreign exchange transactions can currently be conducted between plans subject to ERISA and non-fiduciary parties in interest under PTCE 94-20 (which is available where an independent fiduciary directs the purchase or sale of a specified amount of currency at a specified exchange rate) and PTCE 98-54 (which permits a fiduciary to execute de minimis foreign exchange transactions for a plan with itself or affiliates). Both of these exemptions involve burdensome and non-market conditions. Currently, there is ***no*** exemption available for foreign exchange transactions with IRAs or Keogh plans.

(b) Proposed Change. If adopted, H.R. 4 would provide relief to banks, broker-dealers and their respective affiliates ***(other than fiduciaries that had investment discretion, or provide investment advice to the plan, in connection with the transaction)*** to engage in foreign exchange transactions with the plan, if the following conditions were met:

- The foreign exchange transaction would have to be in connection with a purchase, holding or sale of securities or other investment assets.
- The terms of the transactions would have to be at least as favorable to the plan as the terms generally available, or afforded by the bank, broker-dealer or affiliate, in a comparable arm's-length transaction between unrelated parties.
- The exchange rate could not deviate more or less than 3% from the interbank bid and asked rates as displayed by an independent reporting service.

While the term "foreign exchange transaction" is not defined in the proposed exemption, presumably it would have the same meaning as provided in PTCE 94-20. That exemption covers any exchange of one currency for another, including spots, forwards, splits and options. Also, as the proposed exemption would include foreign exchange transactions in connection with holding of securities or other investment assets, presumably it would cover conversion of dividends and interest payments on any such securities or investment assets purchased.

The proposed exemption would be limited to transactions in connection with the purchase, holding or sale of securities or other investment assets. Financial institutions may wish to begin exploring the viability of reliance on the proposed service provider exemption (if adopted) to conduct foreign exchange transactions not covered by the proposed foreign exchange exemption.

(c) Steps to Consider. Parties in interest and fiduciaries of plans should consider the following if H.R. 4 is adopted:

- Revising compliance procedures to permit transactions that do not qualify for an exemption under current law, for example, permitting transactions with IRAs.

- Permitting foreign exchange transactions to be executed with foreign financial institutions with fewer logistical issues, such as the location of transaction records.

However, care would have to be taken not to permit inadvertently transactions not covered by the proposed exemption. Since transactions not "in connection with the purchase, holding or sale of a security or other investment property" would not be eligible for the proposed exemption, interpretative issues would remain as to exactly what transactions would require a separate exemption.

10. Fiduciary Liability During Investment Blackouts.

(a) Background. No person who is otherwise a fiduciary to an individual account plan is liable under ERISA for any loss, or by reason of any breach, resulting from the exercise of control by a participant or beneficiary over the assets in his or her account so long as the plan meets the requirements under Section 404(c) of ERISA.

(b) Proposed Change. If adopted, H.R. 4 would clarify that relief from liability for losses for persons who would otherwise be fiduciaries would be available during the suspension of participants' or beneficiaries' control over their accounts by reason of blackout periods or changes in investment options ***only*** if the blackout period was authorized and implemented in accordance with Section 101(i)(7) of ERISA and the change in investment options met the following conditions:

- Participants' accounts were reallocated among one or more remaining or new investment options offered in lieu of one or more options offered immediately prior to the effective date of the change and the stated characteristics of the remaining or new investment options immediately after the change were reasonably similar to those of the existing investment options as of immediately before the change.

- At least 30 days and no more than 60 days prior to the effective date of change, the plan administrator gave written notice of the change to participants and beneficiaries, explaining the remaining and new options and

the investment reallocation of their accounts that would occur in the absence of affirmative instructions from the participant or beneficiary to the contrary.

- The investments under the plan in effect immediately prior to the effective date of the change were the product of the exercise by the participant or beneficiary of control over the assets of the account.

(c) Steps to Consider. Plan sponsors and administrators should review and consider amending their procedures for notification and implementation of changes in investments options and blackout periods.

If adopted, this provision would apply to plan years beginning after December 31, 2007 (with special timing provisions for plans maintained under collectively bargained plans).

We note that, to the extent that any of the exemptions described above would provide relief from the restrictions on self-dealing under Section 406(b) of the Code, they would not (as is the case with any exemption from the provisions of Section 406(b)) relieve a fiduciary from its obligations to act prudently and in the best interests of the plan.

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Please feel free to call A. Richard Susko, Arthur H. Kohn, Robert J. Raymond or Mary E. Alcock if you have any questions.

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