

perspective

ERISA for Money Managers: A Practical Workshop

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Common Prohibited Transactions
for Portfolio Management and
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Background -- ERISA

- Purpose of ERISA (the Employee Retirement Income Security Act of 1974, as amended) was to regulate private employer-sponsored pension, profit-sharing and welfare benefit plans, and to protect the funds invested in those plans, for the benefit of plan participants or beneficiaries.
- Overlaps with Advisers Act, but in many cases has more specific requirements as they relate to these types of clients.

Definitions

- ERISA section 3(21)(A) defines a “fiduciary” as a person or entity that (a) has discretionary management or control of a plan’s “assets”; (b) has discretionary authority or control over a plan’s administration; or (c) provides “investment advice” for a fee, with respect to a private employer-sponsored employee benefit plan.
 - Different from the common law or statute, a fiduciary under ERISA is not only someone who has investment management responsibilities, but also administrative responsibilities.
 - Moreover, the provision of “investment advice” (similar to the general requirements of investment advice under the Investment Advisers Act, but not identical) again does not involve investment management, but a broader level of responsibility.
- ERISA section 3(14) defines to include, with respect to any employee benefit plan, plan fiduciaries (including the plan sponsor, trustee, and investment managers) or “a person providing services to such plan” (ERISA section 3(14)(B)).

Who is a Fiduciary?

- An employee, as a corporate agent, does not become a fiduciary solely by reason of being an employee.
- Functional Test: The fiduciary status of an FA or other employee of a fiduciary/employer turns on how much responsibility and control such employee exercises over the plan. If an individual broker exercises discretion on behalf of a fiduciary/employer over a plan's assets or renders investment advice for a fee to a plan, then such individual broker and the employer both are fiduciaries.
- If an individual broker becomes a fiduciary of a plan, it appears that the Department of Labor (the "DOL") takes the position that the compensation paid to that broker must comply with ERISA.
 - If that position were to prevail, compensation differentials based on products sold to plans as to which the broker is a fiduciary would raise issues under ERISA.

Is the Broker-Dealer a Fiduciary – ERISA or Otherwise?

- State Law: Requires detailed review of underlying statutes, especially in the state retirement plan context.
- Advisers Act: Registration and/or holding oneself out as an adviser with respect to a transaction, or through the operation of
- ERISA: A broker-dealer can become an ERISA fiduciary, either directly or through the actions of its FAs/agents, as follows:

Is the Broker-Dealer a Fiduciary – ERISA or Otherwise?

- ERISA (cont'd.):
 - Discretionary Asset Management:
 - *Exercising investment discretion over an account (either by express appointment or de facto established by a pattern of conduct).*
 - *Even execution discretion can result in fiduciary status unless the order (1) specifies the securities or futures to be purchased or sold; (2) specify the maximum and the minimum number of securities or futures to be purchased or sold within the designated price range; (3) specifies a price range in which to purchase or sell; and (4) specifies a time period, not to exceed five business days in the case of securities and one business day in the case of futures, during which the transactions are to be executed.*

Is the Broker-Dealer a Fiduciary – ERISA or Otherwise?

- ERISA (cont'd.):

- ERISA Investment Advice: Rendering tailored investment advice for a fee (which may include the expectation of a commission or a mark up on a principal trade) on a regular basis pursuant to an agreement (which need not be in writing) that such advice is a primary basis for the plan's investment decision.

- *Investment advice*
- *Tailored*
- *Regular basis*
- *Fee (need not be a distinct non-transactional fee)*
- *Agreement (written or otherwise)*
- *A primary basis*

What are ERISA Prohibited Transactions?

- General Rule: Not an overstatement to say that all transactions involving “parties in interest” to an ERISA-covered plan are prohibited, unless there is an exemption for them.
- Fiduciary Self-Dealing: A fiduciary of an ERISA plan or IRA must NOT cause the plan to engage in a self-dealing “prohibited” transaction with the fiduciary, its affiliates or any entity in which the fiduciary has an interest that “might” affect its best judgment as a fiduciary.

What are ERISA Prohibited Transactions – cont'd.

- Fiduciary Self-Dealing: (cont'd.)
 - Can't exercise discretion to cause the plan to pay the fiduciary an additional fee.
 - *Example: with limited exceptions, cannot execute principal trades with the plan or buy or sell forex from or to the plan or engage in asset allocation activities that increase the fee payable to the broker-dealer.*
 - *These rules apply to an individual broker's own IRA and could result in disqualification of the IRA if the broker benefits from a trade by his IRA.*
 - Can't represent a party adverse to the plan in a transaction involving the plan even if done at market.
 - *Example: cannot cross positions between two managed accounts, directly or indirectly using a broker.*
 - Can't get paid from a third party in connection with a plan transaction
 - *Example: cannot get 12b-1 fees if fiduciary exercises discretion to place plan in a mutual fund.*

Types of Exemption

- There are three different types of exemptions:
 - Statutory exemptions (those contained in ERISA or the Code; statutory exemptions apply to anyone who meets the terms of the exemption).
 - *NOTE: The Pension Protection Act expanded the number of “statutory” exemptions.*
 - Class exemptions (exemptions promulgated by the Department of Labor that apply not only to the applicant but to anyone who meets the terms of the exemption)
 - *These exemptions are often requested by industry groups or a few members of an industry group.*
 - *The time to obtain a class exemption is measured in years if not decades*
 - Individual exemptions (exemptions sought by an applicant that only apply to the applicant; others may not rely on those exemptions even if all of the conditions are met)
 - *The time to get an individual exemption may take anywhere from 6 months to decades.*
 - *If the exemption is closely patterned after two recent precedents, the time is reduced under an “ex pro” procedure to 78 days.*

Most Common Class/Individual Exemptions

- The following are some of the most relevant/commonly used class exemptions in the brokerage context:
 - Principal and Agency Transactions by U.S. broker-dealers in securities. PTE 75-1 Parts I and II. Numerous individual exemptions for foreign broker dealer affiliates (see, e.g., individual exemptions issued to Goldman Sachs, Morgan Stanley, Deutsche Bank, UBS and CSFB).
 - Foreign Exchange Transactions PTE 94-20.
 - Securities Lending Transactions to U.S. banks and U.S. broker-dealers. PTE 81-6/2002-16. Numerous individual exemptions for foreign broker dealer affiliates (see, e.g., individual exemptions issued to Goldman Sachs, Morgan Stanley, Deutsche Bank, UBS and CSFB).
 - Repurchase Agreements (not reverse repos where the plan is the borrower of cash) with U.S. banks and U.S. broker-dealers. PTE 81-8.

Most Common Class/Individual Exemptions – Cont'd.

- Purchase and holding of principal protected debt of broker-dealer parent (see, e.g., individual exemptions issued to Goldman Sachs, Morgan Stanley and Deutsche Bank).
- Purchase and holding of asset backed securities. PTE 83-1, supplemented by over 50 individual exemptions issued to financial institutions (see, e.g., Goldman Sachs, Morgan Stanley, Bear Stearns, Deutsche Bank and UBS).
- Agency execution of securities (not futures) trades by a fiduciary. PTE 86-128.
- Principal trades as a market maker by a fiduciary on basis of better than best price. PTE 75-1, Part IV.
- Purchase from another member of a 1933 Act underwriting syndicate by a fiduciary who is not the syndicate manager. PTE 75-1, Part III.

Most Common Class/Individual Exemptions – Cont'd.

- Purchase from another member of a 1933 Act or Rule 144A underwriting syndicate/selling group by a fiduciary when fiduciary is the manager. (See, e.g., individual exemptions issued to Goldman Sachs, Morgan Stanley and Deutsche Bank).
- Fiduciary directing plans into open end, no load mutual funds managed by fiduciary or affiliate so long as there is no double dipping on management fees. PTE 77-4.

Fiduciary Prohibited Transaction Exemptions

- There are very few exemptions that permit fiduciaries to trade with the plan assets over which it is a fiduciary.
 - Agency execution of securities trades. PTE 86-128.
 - Market-maker transaction as principal in a securities trades but only if a number of conditions are satisfied including the condition that the fiduciary reasonably believe that the price to the plan was better than the best price available. PTE 75-1, Part IV.
 - Purchase from another member (i.e., purchase away) of a 1933 Act underwriting syndicate by a fiduciary who is not the syndicate manager. PTE 75-1, Part III.
 - Purchase from another member (i.e., purchase away) of a 1933 Act or Rule 144A underwriting syndicate/selling group when fiduciary is the manager. (See, e.g., individual exemptions issued to Goldman Sachs, Morgan Stanley and Deutsche Bank).
- Given the limited number of exemptions, extreme care and a thoughtful analysis must be undertaken before embarking on any program to create “synergies” between the asset management side (the buy side) and the broker-dealer side (the sell side) of the business.

“Services Exemption” -- ERISA Section 408(b)(2)

- General safe harbor providing that contracts with a party in interest for “services necessary for the establishment of the plan” are permitted so long as no more than “reasonable compensation” is paid.
- Currently the subject of an extensive regulatory proposal from the DOL.

Transactions via ECN or ATS - ERISA Section 408(b)(16) / Code Section 4975(d)(19)

- Generally permits purchases or sales of securities between an ERISA, Keogh or IRA account and a party in interest plan to be executed through a regulated electronic communications network (ECN) or alternative trading system (ATS), if all of the following conditions are met:
 - The transaction is executed through an electronic communication network, alternative trading system, or similar execution system or trading venue subject to regulation and oversight by the applicable federal or foreign regulating entity.
 - Either (i) the transaction is effected pursuant to rules designed to match purchases and sales at the best price available through the execution system in accordance with applicable rules of the SEC or other relevant governmental authority, or (ii) neither the execution system nor the parties to the transaction take into account the identity of the parties in the execution of trades.
 - The price and compensation associated with the purchase and sale are not greater than the price and compensation associated with an arm's length transaction with an unrelated party.
 - If the party in interest has an ownership interest in the system or venue, the system or venue has been authorized by the account owner or other independent fiduciary.
 - Not less than 30 days prior to the initial transaction executed through any system or venue, a plan fiduciary is provided written or electronic notice of the execution of such transaction.

Service Provider Exemption - ERISA Section 408(b)(17)

- Exemption from prohibitions of ERISA Sections 406(a)(1)(A), (B) and (D).
- Applies to transactions occurring after August 17, 2006.
- Statutory exemption provided for certain transactions with service providers who are not fiduciaries (or an affiliate thereof) with respect to the assets involved in the transaction –
 - applies only in connection with a sale, exchange, lease, extension of credit, or transfer of plan income or assets transaction (not payment for services)
 - the plan receives no less, or pays no more than adequate consideration
- Exemption does not apply to a fiduciary (or affiliate) who has or exercises any discretionary authority or control with respect to investment of the assets involved, or provides investment advice with respect to the assets.

Service Provider Exemption - cont'd.

- “Adequate consideration” for this purpose means:
 - For security where there is a generally recognized market, the price of the security on a national securities exchange.
 - If security is not traded on such an exchange, the offering price for the security, taking into account factors including transaction size and market liquidity account.
 - If no generally recognized market, the FMV of asset as determined in good faith by plan fiduciary in accordance with DOL regulations (none exist as of yet).

Service Provider Exemption - cont'd.

- Practical ramifications -
 - Real-world risks, in general and for certain institutions
 - Effect on level of disclosure and other documentation
 - Effect on the need to use other existing exemptions

Foreign Exchange (FX) Transactions – ERISA Section 408(b)(18)

- Permits FX transactions between a broker dealer and ERISA account if –
 - the transaction is in connection with the purchase/holding/sale of securities or other investment assets (i.e., not a currency investment);
 - the terms of the transaction are not less favorable than comparable arms length transactions between unrelated parties;
 - The exchange rate does not deviate by “more or less than 3%” from the interbank bid/ask rates for comparable trades as displayed by independent service; and
 - the broker dealer or its affiliate does not have investment discretion or provide investment advice with respect to the transaction.
- Requirement that exchange rate cannot deviate by “more or less than 3%” is problematic –
 - Probably intended to mean that rate must be within 3% of the interbank rate but without clarification from Congress (through technicals) or DOL there is uncertainty.
 - Also interbank generally only provides rates for large trades so may not be helpful in IRA/small plan market where probably needed most (typically will not have a QPAM).

Prohibited Transaction Correction Period - ERISA Section 408(b)(20)

- Prohibited Transaction Correction Period Without Penalty.
- Added under the Pension Protection Act, new ERISA section 408(b)(20) provides that in the event of a party in interest prohibited transaction, the excise tax is NOT triggered for any transaction involving securities or commodities that is corrected within 14 days after the date the prohibited transaction was either (a) discovered or (b) “reasonably should have been discovered.”
- Does not cover “self-dealing” prohibited transactions (transactions described in section 406(b) of ERISA).

Cross-Trades - PTE 86–128

- Exemption from transactions prohibited by ERISA Section 406(b) and from taxes imposed by Code Sections 4975(a) and (b).
- Allows certain types of agency cross transactions, but not where discretion on both sides.
- Written authorization for transaction needs to be executed in advance by an independent fiduciary of each plan whose assets are involved in transaction, and at least annually, independent fiduciary must be supplied with form allowing him or her to terminate authorization.
- Person seeking exemption must periodically provide certain information.
- Plan must have assets of at least \$50 million (special rule for pooled funds).

Cross Trades - Individual Exemptions

- Subsequent to PTE 86-128, DOL granted individual exemptions for certain agency cross transactions where party has discretion for both sides of transaction.
- These exemptions were subject to additional conditions, such as requirement of prior authorization of each transaction by independent fiduciary, or restriction of coverage to transactions involving particular types of funds or accounts with limited discretion, such as Index or Model-Driven funds.

Cross Trades - PTE 2002-12

- Allows passive cross trades between 2 parties, when the same person is acting for the buyer and the seller – applies to Purchase and sale of securities between an Index Fund or Model-Driven Fund (“Fund”), and another Fund.
- Purchase and sale of securities between such Funds and certain large accounts, pursuant to a portfolio restructuring program of the large accounts.
- Large account generally is an employee benefit plan or institutional investor with at least \$50 million in assets.
- Portfolio restructuring program is a program aimed at (1) producing a portfolio of securities that will be an Index Fund or a Model-Driven Fund, (2) producing a portfolio of securities designated by a party independent of the manager, or (3) liquidating a specified portfolio of securities.

PTE 2002-12 - cont'd.

- Conditions for exemption include:
 - Disclosures to, and authorization by, independent plan fiduciaries (exception is made for in-house plans of manager).
 - Specification of methodology for determining trade price.
 - Description of types of securities that may be cross traded.
 - Imposition of recordkeeping requirements.
 - Exemption does not address cross trades of securities among “actively-managed” accounts.

Cross Trades - ERISA Section 408(b)(19)/Code Section 4975(d)(22)

- Exemption from prohibitions of ERISA Sections 406(a)(1)(A) and 406(b)(2).
- Applies to transactions occurring after August 17, 2006.
- Allows investment manager to execute transactions involving purchase and sale of security between a plan and any other account managed by same investment manager.
- Requirements include:
 - Transaction is purchase or sale for cash against prompt delivery of security for which market quotations are available;
 - Transaction is made at the independent current market price of security;
 - No broker commission, fee, or other remuneration (except for customary transfer fees) is paid in connection with the transaction;

Statutory Cross Trading Exemption (cont'd)

- Requirements (cont'd.) -
 - Fiduciary other than investment manager effecting transaction approves in advance of any cross trades that the investment manager may engage in cross trades at investment manager's discretion;
 - Fiduciary independent from investment manager who authorized cross trading is provided with quarterly report detailing cross trades;
 - Each plan in transaction has assets of at least \$100 million;
 - Investment manager's fee not based on plan's consent to all cross trades, and no other service is conditioned on plan's consent to cross trading;
 - Investment manager adopted, and cross trades are made in accordance with written internal guidelines governing cross trades (interim regulations published); and
 - to monitor compliance with its written guidelines Investment manager designated in-house person.

Statutory Cross Trading Exemption (cont'd)

- Interim Final Rule (Reg. Section 2550.408b-19) governs written policies and procedures that must be adopted before parties can engage in cross trading. Interim Final Rule provides that investment manager's written cross trading policies and procedures must include the following:
 - Statement of policy describing criteria that investment manager will use in determining that cross trade will be beneficial to both participating parties.
 - Description of how investment manager will determine that cross trades are effected at "independent current market price," including identity of sources used to establish price.
 - Description of procedures for ensuring compliance with \$100 million asset size requirement. (Have been suggestions that Treasury permit lesser size plans to engage in cross-trades.)

Statutory Cross Trading Exemption - cont'd.

- Cont'd. -
 - Description of how investment manager will mitigate potentially conflicting division of loyalties and responsibilities to parties involved in transaction.
 - Requirement that investment manager allocate cross trades among accounts in objective and equitable manner, and description of allocation method that will be available and used.
 - Disclosure of identity and qualifications of compliance officer responsible for reviewing investment manager's compliance with written cross trading policies and procedures.
 - Statement describing scope of review conducted by compliance officer.
 - Investment manager may include any other policies and procedures it determines are appropriate to comply with the statutory cross trading exemption.

Securities Lending – PTE 2006-16

- Generally permits loans of ERISA plan (but not Keogh and IRA) securities to a U.S. broker-dealer and certain foreign broker dealers who are non-fiduciary parties in interest, and allows for the receipt of fees or compensation by a plan fiduciary for securities loans, if the following conditions are met:
 - The borrower (and its affiliates) may not have any discretionary authority or control over the account assets involved in the transaction, or render investment advice with respect to those assets (i.e., fiduciary self-dealing).
 - The plan must receive collateral from the borrower in the form of either “U.S. Collateral” or “Foreign Collateral” which are generally defined as follows:
 - *“U.S. Collateral” means (i) U.S. currency, (ii) securities issued or guaranteed by the U.S. government or its agencies or instrumentalities, (iii) certain mortgage-backed securities, (iv) certain negotiable certificates of deposit and bankers acceptances, or (v) certain irrevocable U.S. bank letters of credit (other than those issued by the borrower or its affiliate);*

PTE 2006-16 – cont'd.

- *“Foreign Collateral” means (i) securities issued by or guaranteed as to principal and interest by certain Multilateral Development Banks whose obligations are backed by participating countries, (ii) certain foreign sovereign debt securities, (iii) the British pound, the Canadian dollar, the Swiss franc, the Japanese yen or the Euro, (iv) certain irrevocable foreign bank letters of credit (other than those issued by the borrower or its affiliate); certain forms of collateral described in Rule 15c3-3 of the Exchange Act.*
- The collateral’s market value (or stated amount) as of the close of business on the preceding business day must be at least -
 - *for “U.S. Collateral,” 100% of the then market value of the securities loaned, or*
 - *for “Foreign Collateral,” 102% of the then market value of the securities loaned if the collateral is denominated in the same currency as the securities loaned or 105% of the then market value of the securities loaned if the collateral is denominated in a different currency than the securities loaned.*
- The plan must receive (generally by either physical delivery, wire transfer or book entry in a securities depository) collateral from the borrower by the close of the lending fiduciary’s business on the day in which the securities loaned are delivered to the borrower.

PTE 2006-16 – cont'd.

- The collateral must be marked to market daily. Additional collateral must be posted by the broker-dealer where the value of the collateral falls and excess collateral may be returned to the broker-dealer where the value of the collateral exceeds the loan.
- The loan must be made pursuant to a written agreement, the terms of which must be as favorable to the plan as an arm's length agreement with an unrelated person. (The use of a master securities lending agreement covering a series of transactions is permitted).
- The borrower must provide the lending fiduciary with its most recent audited financial statements, any of its subsequent unaudited financial statements, and a representation that, at the time of the loan, there has been no material adverse change in its financial condition since the date of the most recent financial statements supplied to the plan (except as otherwise disclosed to the lending fiduciary).
- The plan must -
 - *receive a reasonable fee in connection with the transaction, and/or*
 - *have the opportunity be compensated through the investment of cash collateral (in which case the plan may pay, subject to certain restrictions, a loan rebate or similar fee to the borrower).*

PTE 2006-16 – cont'd.

- Cont'd. -
 - The plan must receive the equivalent of all distributions payable in respect to the loaned securities during the term of the loan (i.e., dividends, interest and other rights).
 - The loan must be terminable by the plan at any time, in which case the loaned securities must be returned to the plan within the shorter of (i) the customary delivery period for the securities, (ii) 5 business days or (iii) as otherwise negotiated.
 - The loan agreement must give the plan certain rights in the event of default by the borrower.
 - If the borrower is a foreign broker-dealer, certain additional conditions must be satisfied which generally relate to U.S. jurisdiction and/or indemnification of the plan for any losses as a result of default.

PTE 2006-16 – cont'd.

- For plan fiduciaries to receive a fee in connection with the loan of plan securities, all of the following conditions must be met:
 1. The loan of securities is not a prohibited party in interest transaction or otherwise satisfies the conditions of the exemption.
 2. The lending fiduciary is authorized to engage in securities lending transactions on behalf of the plan.
 3. The compensation is reasonable and is paid in accordance with the terms of a written instrument, which may be a master agreement covering a series of transactions.
 4. Except as otherwise provided in (6) below, the arrangement (i) is subject to the prior written authorization by a plan fiduciary independent of the lending fiduciary and its affiliates (except where the plan covers the employees of the lending fiduciary or its affiliate) and (ii) may be terminated, without penalty, no later than the time negotiated by the parties or five business days.
 5. The lending fiduciary must furnish information necessary to determine whether the authorization should be made or renewed, along with any other reasonably available information requested by the authorizing fiduciary.
 6. Special Rule for Commingled Funds – Bank common or collective funds are exempt from the requirements of section (4) above, provided the (i) information required by section (5) is provided to the independent Plan fiduciary not less than 30 days prior to implementation of the arrangement (or a material change thereto) and any additional information is available upon request, and (ii) where the independent plan fiduciary objects to the new or changed arrangement, the plan is permitted to withdraw, without penalty, within a reasonably short time period before implementation of the arrangement.