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Fiduciary Duty Provisions Affecting Financial Services Providers: Pension Protection Act of 2006

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The Pension Protection Act of 2006 (H.R. 4) (PPA), which the President signed into law today, provides a number of changes and exemptions to the fiduciary duty provisions under the Employee Retirement Income Security Act of 1974 (ERISA) and the prohibited transaction rules under both ERISA and the Internal Revenue Code of 1986, as amended (the Code) that directly affect how financial services providers will interact with plans subject to ERISA fiduciary provisions and tax-qualified retirement and savings accounts, including new rules on participant-level investment advice, general and specific relief on prohibited transaction issues, changes in the ERISA bond requirements and liberalization of the plan asset rules which impact hedge funds and other alternative pension investments. This LawFlash, the second in our series on the PPA, addresses those important revisions to the law in this area.

Plan Participant-Level Investment Advice

The PPA contains an exemption that permits an adviser, acting as a fiduciary, to provide participant-level investment advice, for an additional fee, within a participant-directed plan (such as a 401(k) plan), when such advice is provided pursuant to an "eligible investment advice arrangement." The significance of this exemption is that it permits an adviser to provide fiduciary advice regarding investment funds and products with respect to which the adviser is affiliated or from which the adviser receives, directly or indirectly, additional compensation. However, the practical application of this relief may be fairly limited, as advice provided under the computer model arrangement (discussed more fully below) seems to be limited to nondiscretionary advice only, which is in contrast to many of the new discretionary products currently coming into the marketplace.

Eligible Investment Advice Arrangements: Eligible investment advice arrangements can be structured as either (i) fee neutral (i.e., the adviser's total compensation for the advice, including indirect compensation generated by the actual securities that are purchased or sold in reliance upon such advice, does not vary based on the advice given) or (ii) based on a computer model. The fee-neutral approach seems similar to the fee-offset approach currently employed in wrap-fee programs, where a fixed program fee is charged and offset by certain types of compensation (such as 12b-1 fees) that are earned by the adviser (or its affiliates) from the investment products used in the program. Thus, the adviser's aggregate fee is not affected by the actual investment allocation of the account. However, questions are already arising as to whether the fee neutrality provision under the PPA applies exclusively to the

compensation received by the adviser, without considering indirect compensation earned by the adviser's affiliates.

Alternatively, an eligible investment advice arrangement based exclusively on advice generated by a computer model permits the adviser's (and its affiliates') aggregate compensation with respect to the advice to vary based on the advice given. The computer model must be certified by an "eligible investment expert" (i.e., someone without a material affiliation or contractual relationship with the adviser who also meets other requirements that the Department of Labor [DOL]) may specify from time to time) that it applies generally accepted investment theories, uses relevant participant information (e.g., age, retirement date, risk tolerance), and operates in a manner not biased in favor of investments offered by the adviser (or its affiliates). The elements of this computer model driven advice exemption are very similar to the concepts developed in the DOL's *SunAmerica Letter* (AO 2001-9A, December 2001). This exemption, however, takes the *SunAmerica* concept of a "financial expert" one step further by permitting the adviser, as opposed to requiring an unrelated third party, to actually develop and maintain the computer model, as long as the model is certified by an eligible investment expert. In a significant departure from the *SunAmerica* approach, advice provided under this computer model exemption seems limited to nondiscretionary advice, where *SunAmerica* specifically applied to both discretionary and nondiscretionary participant-level advice programs.

Other Conditions: Other conditions of this exemption include an annual audit of the adviser by an independent auditor, express authorization by a plan fiduciary (independent of the adviser), and a number of disclosures, including an acknowledgement of ERISA fiduciary status, to be provided to the advice recipient by the adviser. The PPA requires the DOL to issue a model form of disclosure to meet the requirements of this exemption.

Relief for Plan Sponsors: The PPA also offers relief to plan sponsors (or other plan fiduciaries) that choose to make an "eligible investment advice arrangement" available to plan participants. From the beginning of the development of participant-level advice products, plan sponsors have generally been concerned that offering such products could increase their fiduciary liability exposure. Specifically, plan sponsors (or other plan fiduciaries) have no obligation (fiduciary or otherwise) to make investment advice available to plan participants, but once they do, the plan sponsor (or the plan fiduciary) must act prudently with respect to choosing and monitoring the provider it makes available. The PPA provides that a plan sponsor (or other plan fiduciary) will not violate its standard of care to the plan where it arranges for the provision of investment advice to plan participants under an eligible investment advice arrangement, where the advice provider is prudently selected and periodically reviewed by the plan sponsor (or other plan fiduciary). Most important, the PPA goes on to provide that periodic monitoring does not require the monitoring of any specific investment advice given to any particular participant. However, what is left unanswered is how and what a plan fiduciary is supposed to monitor under this relief. In any case, as this protection for the plan sponsor (or other plan fiduciary) applies only to "eligible investment advice arrangements," it is foreseeable that market pressure may force *SunAmerica*-type programs to be reconfigured as necessary to meet the elements of an eligible investment advice arrangement in order for plan sponsors to take advantage of this provision.

IRA and Other Tax-Qualified Accounts: The PPA requires the DOL, in consultation with the Secretary of the Treasury, to determine the feasibility of using a computer model investment advice program for IRAs, Archer MSAs, health savings accounts, and Coverdell education accounts. Accordingly, these tax-qualified accounts are not permitted to use the computer model advice portion of the exemption

until the DOL makes a finding that it is permissible or grants an alternative exemption for such accounts. Accordingly, at least in the short run, advisers may be running different advice programs for their 401(k) and IRA markets.

Effective Date: This relief applies to advice provided after December 31, 2006.

Block Trades

The PPA provides an exemption from the prohibited transaction rules of ERISA and the Code for the purchase or sale from a nonfiduciary party in interest of a "block trade" (defined as a trade of at least 10,000 shares or a market value of at least $200,000) that is allocated across two or more unrelated client accounts. The transaction has to involve a block trade, not more than 10% of the block trade can be attributable to any one plan (together with interests of all plans of the same plan sponsor), the terms of the transaction must be as favorable to the plan as an arm's-length transaction, and the compensation associated with the purchase and sale is not greater than the compensation associated with an arm's-length transaction.

As this provision does not apply to transactions between a plan and a fiduciary, its utility seems fairly limited. Specifically, principal transactions between a nonfiduciary broker-dealer (i.e., a transaction where neither the broker-dealer nor any of its affiliates exercise any discretionary authority or control or provides investment advice with respect to the plan assets involved in the transaction) are already covered under Prohibited Transaction Class Exemption (PTCE) 75-1, Part II. At issue is the situation in which a broker-dealer (or its adviser affiliate) allocates (either in a discretionary arrangement or pursuant to investment advice) plan assets to an unrelated adviser who chooses to execute trades through the broker-dealer. In such a situation, the broker-dealer would arguably be precluded from executing on a principal basis under PTCE 75-1 Part II, as it did act in a fiduciary capacity with respect to the assets involved in the transaction. Thus, for this provision to be of real utility, it would have to apply to fiduciaries.

Effective Date: This exemption applies to transactions conducted after the date of enactment.

Bonding Relief for Broker-Dealers

The PPA provides an exclusion from ERISA's bonding requirements for registered broker-dealers subject to the fidelity bonding requirements of a self-regulatory organization (SRO). ERISA generally requires all fiduciaries with discretionary authority over plan assets and persons who "handle" plan assets to be bonded. Broker-dealers should check with their risk management group to determine if they can take advantage of this potential cost savings reduction in coverage. Nevertheless, many investment management agreements and other types of fiduciary arrangements may, as an existing contractual requirement, require the broker-dealer to maintain this coverage regardless of this statutory relief.

Effective Date: This relief applies to plan years beginning after the date of the PPA's enactment.

Increase in Maximum Bond Amount

The PPA increases ERISA's maximum bond amount from $500,000 to $1,000,000 for plans that hold "employer securities." ERISA generally requires all fiduciaries (except for certain banks, trust companies, insurance companies, and now registered broker-dealers; see above) with discretionary authority over plan assets and persons who "handle" plan assets to be bonded in an amount equal to 10% of the amount of funds handled, but not less than $1,000 nor more than $500,000 (except for plans holding employer securities, then the maximum amount is $1,000,000). As discretionary investment advisers (including hedge fund and private fund managers) and other financial services companies that handle plan assets remain subject to ERISA's bonding requirements, they will want to ensure that to the extent that they currently maintain a bond for their ERISA clients, the coverage of the bond increases to meet this new requirement.

Effective Date: This increase will become effective for plan years beginning after December 31, 2007.

Codification of the "Blind Transaction Doctrine" and the *Liquidnet Letter*

The PPA seems to codify and expand both the "blind transaction doctrine" as provided for in ERISA's original legislative history and the DOL's *Liquidnet Letter* (DOL AO 2004-04A, May 2004). Specifically, the PPA provides a prohibited transaction exemption under ERISA and the Code for securities transactions (and transactions of other types of property as determined by the DOL, which may include futures contracts and currency trades) between a plan and a party in interest that are executed through an electronic communications network (ECN), an alternative trading system (ATS), or a similar execution system or trading venue that is subject to either federal or, in certain circumstances, foreign regulatory oversight. To qualify for the exemption, the following conditions must be met: (i) the price and commission associated with the transaction is no greater than that associated with an arm's-length transaction; (ii) either (A) the transaction is effected pursuant to rules designed to match purchases and sales at the best price available or (B) neither the execution system nor the parties to the transaction take into account the identity of the parties in the execution of trades; (iii) if the party in interest has an ownership interest in the execution system, a plan fiduciary, independent of the party in interest, authorizes such transaction; and (iv) not less than 30 days prior to the initiation of such transactions, a plan fiduciary is provided written or electronic notice of the use of such trading system.

It is not clear on its face whether this provision applies to national securities exchanges as well. If so, this would represent an expansion of the blind transaction doctrine, as provided for in ERISA's legislative history, which applies to transactions executed through an exchange where the parties do not know each other's identity. This provision also represents an expansion of the *Liquidnet Letter*, in which the DOL expanded the blind transaction doctrine to cover ATS transactions where the parties did not know or have reason to know each other's identity. Significantly, there is no knowledge restriction with respect to the identity of the counterparty (or potential counterparties) in the PPA.

Owners of Execution Systems: Also unclear in this provision is whether its terms are broad enough to cover fiduciary prohibited transactions (i.e., self-dealing, duty of loyalty, kickbacks). Although we understand that this provision was intended to cover such transactions, it is not clear by its terms that it covers the situation in which an adviser, acting as a discretionary fiduciary for a plan client, places trades through a trade execution system in which the adviser or its affiliate has an ownership interest.

Effective Date: This exemption applies to transactions conducted after the date of enactment.

Broad Relief for Transactions with Plan Service Providers

The PPA provides a broad exemption from the prohibited transaction rules under ERISA and the Code for certain transactions between a plan and its nonfiduciary service providers, which is similar to the protections afforded by the so-called QPAM exemption (PTCE 84-14) without the conditions required thereunder.

Specifically, this exemption applies to sales or exchanges, leases, and extensions of credit between a plan and a party in interest (other than a party in interest who is a fiduciary [or an affiliate thereof] who has or exercises discretionary authority or control over or provides investment advice with respect to plan assets involved in the transaction), where the plan receives no less, nor pays no more, than "adequate consideration." Adequate consideration is defined to mean (i) in the case of a security for which there is a generally recognized market, either (A) the prevailing price on a national securities exchange (taking into account factors such as transaction size and security marketability) or (B) if not traded on a national security exchange, a price not less favorable to the plan (taking into account factors such as transaction size and security marketability) than the offering price for the security as established by current bid and asked prices quoted by persons independent of both the security issuer and the party in interest claiming the exemption, and (ii) in the case of assets other than a security for which there is a generally recognized market, the fair market value of the asset as determined in good faith by a plan fiduciary in accordance with regulations to be prescribed by the DOL.

Effective Date: This exemption applies to transactions conducted after the date of enactment.

Liberalization and Clarification of the So-Called 25% Exception to the DOL's Plan Asset Regulation

The PPA liberalizes how to calculate significant benefit plan investor (BPI) participation in private investment funds by limiting the definition of BPI to only (i) plans subject to the fiduciary provisions of ERISA, (ii) plans subject to the Code's prohibited transaction rules, and (iii) entities (such as private investment funds) deemed to hold plan assets under the DOL's regulations. Thus, governmental, foreign, and certain church plans are no longer included in the calculation. This provision also clarifies that in the context of a fund of funds, master-feeder, or other situation in which one private investment fund invests in another, the investing fund that holds plan assets only holds plan assets to the extent of its BPI investors. Thus, from a practical standpoint, the use of multiple feeder funds to separate the ERISA/Code plan investors from other non–ERISA/Code plan investors may no longer be necessary.

That being said, the 25% Exception is still set at 25%—as opposed to the 50% limit that was being lobbied for—of any class of equity interest after the most recent acquisition (we believe the DOL will maintain its position that the testing date includes redemptions that change the ownership interests of the remaining investors), after disregarding interests held by individuals (or their affiliates) who either exercise discretionary authority or control over the investment fund's assets or provide the investment fund investment advice for a fee. One issue that this provision does not clear up is the application of the test on a class-by-class basis. It was hoped that this legislation would remove this requirement and apply the test on the private fund's aggregate assets and aggregate owners.

Although this provision does not go as far as many had hoped, it does provide a number of welcome changes. Specifically, limiting BPIs to ERISA plans and plans subject to the Code's prohibited transaction rules should free up substantial capacity in many funds operating close to the 25% limit. Moreover, clarifying that a fund holding plan assets only holds plan assets to the extent of its BPI investors should help fund advisers streamline fund structures and avoid unnecessary feeder funds or other structures used to control BPI interests.

Finally, as the PPA does not codify the DOL's plan asset regulations, but merely modifies and limits how the 25% Exception is calculated under the regulations, the DOL has authority to make additional changes to the definition of plan assets.

Effective Date: These changes apply to transactions conducted after the date of enactment.

Active Cross Trades for Large Plans

The PPA contains a long-awaited prohibited transaction exemption under ERISA and the Code for active cross trades. For purposes of this exemption, "cross trade" means the trading of securities between a "large plan" and another account managed by the same adviser who meets the definition of an "investment manager" under ERISA or the Code. This exemption is only available for large plans (meaning plans with assets of or part of a master trust with assets of $100 million or more) where (i) the transaction is a purchase or sale for no consideration other than cash payment against prompt delivery of a security for which market quotations are available; (ii) the transaction is effected at the independent current market price of the security; (iii) no brokerage commission, fee (except certain customary transfer fees, where certain advance disclosures are made), or other remuneration is paid in connection with the transaction; (iv) a plan fiduciary independent of the investment manager authorizes, in advance and in a document separate from any other written agreements of the parties, the ability of the investment manager to conduct such cross trades; (v) the investment manager provides the plan fiduciary written disclosure, in a separate writing, of the conditions under which cross trades can occur; (vi) the investment manager provides the plan quarterly reports detailing all cross trades executed in the quarter; (vii) the investment manager does not condition its fees on the use of cross trades or charge a higher fee where the plan fiduciary refuses to permit cross trades under this exemption; (viii) the investment manager has adopted certain written cross-trading policies and procedures that provide for the allocation of cross trades among participating accounts in an objective manner; and (ix) the investment manager shall designate an individual responsible for periodically reviewing cross trades to ensure that they were conducted in conformity with the manager's policies and procedures and to certify, under penalty of perjury, to the plan fiduciary, such persons' findings and conclusions.

No later than 180 days after the PPA's enactment, the DOL, after consultation with the SEC, is required to issue regulations regarding the content of the policies and procedures to be adopted by the manager.

Effective Date: This exemption applies to transactions conducted after the date of enactment.

Correction Period for Certain Transactions Involving Securities and Commodities

The PPA provides a mechanism for correcting securities or commodities transactions that inadvertently violate the nonfiduciary prohibited transaction rules under ERISA or the Code. Specifically, the PPA permits the correction, within a 14-day correction period, of certain securities or commodities transactions. The relief only applies to the nonfiduciary prohibited transaction rules (i.e., it does not apply to instances of fiduciary self-dealing, breaches of loyalty, or the receipt of kickbacks). Moreover, it neither applies to transactions between a plan and a plan sponsor with respect to the purchase or sale of an employer security or the acquisition, sale, or lease of any employer property, nor transactions where the fiduciary or other party in interest knew or reasonably should have known that the transaction would constitute a nonexempt prohibited transaction.

To qualify for this exemption, the transaction must be undone to the extent possible, the plan must be made whole for any losses resulting from the transaction, and profits made by the party in interest through the use of the plan's assets must be restored to the plan. The correction must be completed by the end of the 14-day correction period, which starts on the day that the fiduciary either discovers, or reasonably should have discovered, that the transaction would constitute a nonexempt prohibited transaction under ERISA Section 406(a) or the corresponding provisions under the Code.

As many of the inadvertent nonfiduciary prohibited transactions covered by this exemption will occur with respect to a party in interest who is a party in interest by virtue of being a service provider (i.e., the purchase by a plan of a bond issued by a plan service provider), many of the potential transactions that this provision would have been helpful in addressing prior to the PPA may already be exempt under the "Broad Relief for Transactions with Plan Service Providers" discussed above. Furthermore, the use of the subjective "should have known" and "should have discovered" standards will cause much uncertainty with respect to relying on this exemption.

Effective Date:. This exemption applies to transactions discovered, or which reasonably should have been discovered, after the date of enactment.

Relief for Foreign Exchange Transactions

The PPA provides an exemption from the prohibited transaction rules for foreign exchange (FX) transactions between a plan and a bank, broker-dealer, or an affiliate thereof, which is a trustee, custodian, fiduciary, or other party in interest with respect to such plan. Under the exemption, (i) the FX transaction is in connection with the purchase, holding, or sale of securities or other investment assets (other than an FX transaction unrelated to any other investment in securities or other investment asset); (ii) at the time of the FX transaction, the terms are no less favorable to the plan then the terms available in a comparable arm's-length FX transactions; (iii) the exchange rate used does not deviate by more then 3% from the inter-bank bid and asked rates for transactions of comparable size and maturity as displayed on an independent service that reports such rates of exchange; and (iv) the bank or broker-dealer (or any affiliate of either) does not have investment discretion or provide investment advice, with respect to the transaction.

Effective Date: This exemption applies to transactions conducted after the date of enactment.

The PPA contains a number of items that we understand will be fixed or clarified in technical corrections to be adopted once Congress reconvenes after its summer break. As such technical corrections are adopted, we will keep you up to date.

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