Important Legislative Changes to ERISA's "Prohibited Transaction" Rules

The recently enacted Pension Protection Act of 2006 (the "Act") makes important changes to the "prohibited transaction" rules applicable to employee benefit plans under the Employee Retirement Income Security Act of 1974 ("ERISA") and the Internal Revenue Code.[1] The changes, most effective for transactions after August 17, 2006, will greatly enhance the ability of plans and their managers to engage in a variety of ordinary-course financial transactions.

Background

Section 406(a) of ERISA prohibits a broad range of transactions between plans and so-called "parties in interest" (including *inter alia* plan sponsors, fiduciaries, other providers of services to the plan, and certain related parties). Section 406(b) of ERISA prohibits transactions by a fiduciary that involve self-dealing, conflicts of interest or payments to the fiduciary by other parties to the transaction. Although ERISA itself contains some exemptions to these prohibitions and authorizes the Department of Labor to issue others on an individual or class basis, in many cases the limited scope of exemptive relief has meant that otherwise unobjectionable financial dealings by plans have had to be limited or restructured.

Plan asset vehicles

For some asset managers, the most significant change made by the Act is in the rules for determining when an asset pool (*e.g.*, a hedge fund) will be treated as holding "plan assets" subject to ERISA. The changes in this area will mean that certain funds will no longer be subject to ERISA's fiduciary-duty rules and will no longer have to worry about ERISA's prohibited-transaction provisions unless the fund itself is a "party in interest." For more discussion of this critical change, *see* our Alert of August 4, 2006 (and, for its specific application to hedge funds, the Alert of August 9, 2006). Simply stated, under the new rule a fund will not be subject to ERISA if less than 25% of each class of equity interest in the fund is held by plans subject to ERISA's or the Code's prohibited transaction rules. Under prior law, investment by plans exempt from ERISA, such as governmental plans, foreign plans and church plans, counted towards the 25% threshold.

Transactions with service providers

A provider of financial or other services to a plan, and its affiliates, are plan "parties in interest." Prior to the Act there was no comprehensive statutory exemption for investment transactions with service providers, although various individual or class exemptions — including a class exemption covering transactions involving a so-called "qualified professional asset manager" or QPAM — provided some relief where they applied.

Under the Act, with limited exceptions, most of the Section 406(a) prohibitions will not apply if the party transacting with the plan is a party in interest solely by reason of being a service provider (or a related person) and the plan receives no less and pays no more than "adequate consideration." The new exemption does not apply to the furnishing of goods,

[1] For ease of discussion, the summaries in this Client Alert refer to affected provisions of ERISA, but the Act makes parallel changes to the corresponding prohibited-transaction provisions of the Internal Revenue Code.

services, or facilities between a plan and a party in interest or to acquisitions of employer securities or employer real property, but existing exemptions provide some relief in these areas already. The new exemption also does not apply where the service provider is a fiduciary (or an affiliate) with discretionary authority or control over the investment of the plan assets involved in the transaction or who renders investment advice with respect to those assets. "Adequate consideration" is determined by reference to the market in the case of traded securities for which there is a generally recognized market, taking into account factors such as the size of the transaction and the marketability of the security, and fair market value (determined under regulations to be issued by the Department of Labor) in the case of other assets.

The new "service provider" exemption should simplify compliance efforts with respect to a number of transactions that until now have had to satisfy the conditions of the QPAM exemption or of one of several other class or individual exemptions.

Cross-Trades

Prior to the Act, cross-trades between ERISA accounts managed by the same manager were widely viewed as prohibited absent an exemption. Existing class-exemption relief was limited to certain formula- or program-driven cross-trades.

The Act adds a statutory exemption for cross-trades involving securities. The exemption applies to transactions described in Section 406(a)'s prohibition against sales or exchanges between the plan and a party in interest and Section 406(b)'s prohibition against a fiduciary acting in a transaction that involves a conflict of interest. The transaction covers only cash transactions between accounts managed by the same manager at the "independent current market price" (defined by reference to Investment Company Act regulations) for securities for which market quotations are readily available. For the exemption to apply, no brokerage commissions, fees (other than customary transfer fees, if the fact of such fees has been disclosed) or other remuneration can be paid in connection with the transaction, and each plan involved in the transaction (or the master trust, if the plan is part of a master trust) must have assets of at least $100,000,000. The exemption is also conditioned on the satisfaction of detailed procedural, disclosure and approval safeguards.

Block Trades

The Act provides a statutory exemption for "block trades" with parties in interest, defined as any trade of at least 10,000 shares *or* with a value of at least $200,000 that will be allocated over two or more unrelated client accounts of a fiduciary, so long as the interest of the plan and of certain related plans in the transaction does not exceed 10% of the aggregate size of the trade, the trade is on terms (including price) not less favorable to the plan than 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. One limiting aspect of the new exemption is that it does not exempt transactions with a fiduciary of the affected plan – apparently regardless of whether the fiduciary has any discretion or control with respect to the assets being traded. It is also unclear from the statutory language how the two-or-more-client-accounts requirement will be construed.

Electronic Communication Networks

The Act for the first time provides a comprehensive exemption from the prohibited transaction rules for transactions involving securities (or other property as determined by the Department of Labor) accomplished through an electronic communication network, alternative trading system, or "similar" execution system or trading venue subject to U.S. federal (or, to the extent Department of Labor regulations provide, non-U.S.) regulation and oversight. The exemption will apply only if (i) the transaction is effected pursuant to rules designed to match purchases and sales at the best price avail-

able through the execution system (in accordance with applicable SEC or other regulatory requirements) or the transaction is "blind" to the identity of the parties, (ii) the price and compensation associated with the transaction are not greater than in an arm's length transaction, (iii) disclosure is made to a plan fiduciary not less than 30 days prior to the first transaction, and (iv) if the party in interest has an ownership interest in the system or venue, the system or venue has been authorized for transactions by the plan sponsor or an independent fiduciary.

Foreign exchange transactions

There is currently no statutory exemptive relief for foreign exchange transactions, although the Department of Labor has issued two relatively restrictive class exemptions. The Act now exempts "foreign exchange transactions" involving banks and broker-dealers (or their affiliates) in connection with the purchase, holding or sale of securities or other investment assets, if the transaction is on arm's-length terms, the bank or broker dealer (and their affiliates) do not have investment discretion or provide investment advice with respect to the transaction, and the exchange rate does not deviate by more than 3% from inter-bank bid and asked rates independently reported for contemporaneous transactions of comparable size and maturity.

Correction of certain prohibited transactions

Non-exempt prohibited transactions generally give rise to liability for losses suffered by a plan as well as either an excise tax under the Internal Revenue Code or a civil penalty under ERISA. Given the complexity of the party-in-interest rules, inadvertent violations sometimes occur. Under the law as in effect prior to the Act, prohibited-transaction foot-faults, even if trivial and corrected promptly upon discovery, could result in burdensome disclosures and filings on top of the tax or penalty cost.

The Act now provides relief for inadvertent Section 406(a) transactions involving securities or commodities (other than transactions with the plan sponsor and its affiliates involving employer securities or employer real property) if the prohibited transaction is corrected within 14 days of when the fiduciary or party in interest discovers, or reasonably should have discovered, that the transaction violated Section 406(a). Correction for this purpose must make good any losses to the plan and restore any profits made with the plan assets.

The new correction rule applies to prohibited transactions that are *discovered* (or should reasonably have been discovered) after August 17, 2006.

Investment advice under self-directed plans

There has long been a need to provide participants in self-directed individual account plans (most 401(k) plans, for example) with more effective access to professional investment advice. However, advisers have been deterred, in part, by ERISA's prohibited-transaction rules.

The Act broadly exempts from the prohibited-transaction rules the giving of advice and related transactions and fees if the program is an "eligible investment advice arrangement." To qualify for the exemption, the adviser must either (i) use a computer model that is not biased in favor of particular plan investments and that satisfies certain other safeguards, or (ii) receive compensation that does not vary depending on the investment selected. The advice arrangement must be authorized by a fiduciary independent of the advice fiduciary, there must an annual audit to ensure compliance with the exemption requirements, the advice fiduciary must provide participants with detailed disclosure (the Act sets out extensive requirements), and transactions must be on arm's-length terms, with no more than reasonable compensation to the advice fiduciary and its affiliates, and must occur solely at the direction of the advice recipient. Other requirements also apply. In general, the new exemption applies to advice provided after December 31, 2006, but a delayed effective date applies in the case of computer model investment advice provided with respect to IRAs and certain other individual accounts.

Other – bonding relief

Although not a "prohibited transaction" reform, the Act has relaxed ERISA's bonding rules as applied to broker-dealers. The new rule, applicable to plan years beginning after August 17, 2006, relieves registered broker-dealers of the need to obtain an ERISA bond if they are subject to the self-regulatory organization fidelity bond rules of the Securities Exchange Act of 1934, as amended. (A separate change in the bonding rules, with a later effective date, increases the bonding requirement, where it applies, in cases involving employer securities.)

What steps should be taken in view of these changes?

In view of the Act's liberalization of ERISA's prohibited-transaction rules, plan sponsors, plan fiduciaries and other providers of services to plans should review disclosures, agreements and procedures to reassess, and where appropriate eliminate or simplify, ERISA-related undertakings. The changes to the investment-advice rules may prompt sponsors of 401(k) and other individual-account plans to reconsider advice programs and will likely increase the interest among advice professionals in offering such programs.

Contact information

For additional information concerning the changes noted above, contact any member of the ERISA/employee benefits group within the Tax & Benefits Department.

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