K&LNG Alert

AUGUST 2006

Investment Management/ERISA Fiduciary

New Prohibited Transaction Rules and ERISA Fidelity Bond Requirements

The "Pension Protection Act of 2006" (the "Act"), recently passed by Congress and awaiting the President's signature, makes the most significant changes to standards governing the conduct of employee benefit plan fiduciaries since the enactment of the Employee Retirement Income Security Act of 1974 ("ERISA") over three decades ago. This Alert focuses on changes to the prohibited transaction restrictions of ERISA and the Internal Revenue Code of 1986 (the "Code") that affect investment advisers, broker-dealers, and others that provide financial services to plans (either directly or indirectly through entities whose assets are considered to include "plan assets" for ERISA purposes). This Alert also discusses changes to ERISA's fidelity bond requirements.[1]

SUMMARY OF CHANGES

The Act creates new exemptions from the prohibited transaction provisions of ERISA and Section 4975 of the Code for the following types of transactions involving plans:

- Block trading of securities and, potentially, other property
- Trades effected through an electronic communication network
- A wide range of transactions between a plan and a person who is an existing, non-fiduciary service provider to the plan
- Foreign exchange transactions
- Discretionary cross trades

These transactions would be prohibited under ERISA in the absence of an exemption if they involve a plan and a "party in interest" or "disqualified person"[2] or otherwise involve violations of restrictions on fiduciary self-dealing and conflicts of interest. A fiduciary who causes a plan to engage in a transaction that the fiduciary knows or should know involves a party in interest is liable under ERISA for breach of fiduciary duty. In addition, a party in interest that engages in a prohibited transaction is exposed to excise tax liability under Section 4975 of the Code.

While the changes to the prohibited transaction restrictions largely are beneficial to investment managers and financial institutions in the sense that there will be several additional exemptions to rely upon in conducting day-to-day operations, the benefits come with a price. As is the case with existing statutory exemptions, each of the new exemptions has a number of specific conditions to be

[1] The changes to the prohibited transaction rules and fidelity bond requirements are contained in Act Section 611. The Act makes two other fundamental changes to ERISA's fiduciary rules: (1) fiduciaries of 401(k) plans may provide investment advice to plan participants under certain conditions, even if the fiduciaries receive direct or indirect compensation that may vary based on the nature of the advice; and (2) the rules governing the treatment of assets of unregistered investment funds as "plan assets" are changed to permit ERISA plans to make greater investments in such funds without the assets of the funds being treated as "plan assets" for purposes of ERISA or the prohibited transaction excise tax provisions of the Code. For a copy of our Alert regarding the Act's new "plan asset" rules as well as our Alert on the investment advice provisions of the Act, please contact any of the persons listed on the last page of this Alert, or visit the K&LNG website, www.klng.com.

[2] In general, ERISA uses the term "party in interest" and the Code uses the term "disqualified person." For purposes of this Alert, references to "party in interest" include "disqualified person," unless specifically stated otherwise. This Alert uses the term "fiduciary" as that term is defined in ERISA or the Code, as applicable.

satisfied. Consequently, institutions intending to rely on the new exemptions will need to review and revise their existing compliance procedures to ensure that the new conditions are taken into account (as well as to eliminate unnecessary references to, or policies limited by, prior exemptions).

The Act also permits fiduciaries to correct certain inadvertent prohibited transactions involving securities or commodities without penalty or liability if correction is accomplished within 14 days of discovery and, once again, if certain additional conditions are satisfied. Finally, the Act also provides relief from the fidelity bond requirements of ERISA for U.S. registered broker-dealers.

Effective Dates

The new prohibited transaction exemptions are effective with respect to transactions occurring after the date of enactment. The new provision permitting correction of certain prohibited transactions involving securities or commodities is effective with respect to transactions that are discovered—or "reasonably should have been discovered"—after the date of enactment to constitute prohibited transactions. The ERISA fidelity bond changes are effective for plan years beginning after the date of enactment.

NEW PROHIBITED TRANSACTION EXEMPTIONS

Block Trades

New ERISA Section 408(b)(15) permits block trades of securities between a plan and a party in interest (other than a fiduciary) with respect to the plan.[3] In general, the new exemption applies to purchases and sales of securities between a plan and party in interest if:

- the transaction "involves a block trade;"
- no plan (or group of plans maintained by the same plan sponsor) participating in the block trade accounts for more than 10% of the aggregate size of the block trade;
- the price and other terms of the transaction are at least as favorable to the plan as an arm's-length transaction with a person that is not a party in interest; and
- the compensation "associated with" the transaction is not greater than the compensation associated with an arm's length transaction with a person that is not a party in interest.

A "block trade" is a trade of at least 10,000 shares or having a market value of at least $200,000 that will be allocated across at least two unrelated client accounts of a fiduciary. Although the new exemption applies only to purchases and sales of securities, it authorizes the Secretary of Labor to extend the exemption to other types of property.

Impact

The U.S. Department of Labor ("DOL") already has issued administrative exemptions that permit the purchase and sale of securities between a plan and certain types of parties in interest. Prohibited Transaction Exemption ("PTE") 75-1, Part II, for example, in general permits plans to engage in principal transactions involving securities with U.S. registered broker-dealers if certain conditions are satisfied. The "qualified professional asset manager" ("QPAM") exemption permits securities transactions between plans and parties in interest. In each of those cases, however, it may be difficult to satisfy the applicable conditions. (For example, PTE 75-1, Part II would not apply if the transaction does not involve a broker-dealer or affiliate. Similarly, it may not be feasible for a QPAM effecting a transaction for multiple plans to determine whether the various transactional requirements of that exemption have been satisfied.) If its conditions are satisfied, the new exemption may be available to fill in where the existing exemptions do not apply.

An important interpretive issue relates to the fact that the new exemption applies only to transactions involving a party in interest "other than a fiduciary." DOL generally has taken the position that a person is considered a "fiduciary" with respect to a transaction only if that person performs fiduciary functions for the plan in connection with the transaction. This suggests that the new exemption should be

[3] Because the prohibited transaction provisions of Section 406 of ERISA and Section 4975 of the Code are largely identical, this Alert's discussion of the ERISA changes includes the corresponding changes to Section 4975 of the Code, except where explicitly stated otherwise.

construed to permit block trades between plans and fiduciary parties in interest who are not acting on behalf of the plan with respect to the block trade. It remains to be seen whether the DOL (or a technical corrections bill) provides further guidance on the issue.

Trades Executed Through Electronic Communication Networks

New ERISA Section 408(b)(16) permits the purchase or sale of securities between a plan and a party in interest if:

- the transaction is executed through an "electronic communication network, alternative trading system, or similar execution system or trading venue" ("ECN") that is subject to regulation by a U.S. regulatory authority or, if the DOL so determines, a foreign regulatory authority;
- either (i) the transaction is executed "pursuant to rules designed to match purchases and sales at the best price available through the execution system," as required by the rules of the Securities Exchange Commission ("SEC") or other applicable "governmental" authority, or (ii) the identity of the parties to the trade is not taken into account by either the execution system or the parties to the transaction;
- the price of the transaction and related compensation are not greater than the price and compensation in an arm's-length transaction with a person that is not a party in interest;
- if the party in interest has an ownership interest in the ECN, an independent fiduciary authorizes the use of the ECN; and
- at least 30 days before the initial transaction through the ECN, a plan fiduciary is provided written or electronic notice of the execution of such transaction.

Impact

ERISA's legislative history indicates that "blind" market transactions involving plan assets should not be viewed as prohibited even though a transaction may involve a party in interest. This principle has been generally accepted by both the DOL and the industry. Although DOL has indicated that the "blind transaction" principle is also applicable, in at least some circumstances, to transactions effected through ECNs, it has not been clear whether the blind transaction principle would protect a fiduciary from executing a transaction on an ECN in circumstances where the fiduciary can deduce the identity of the party on the other side of the transaction with reasonable certainty. The new exemption apparently resolves that concern.

However, a transaction through an ECN can also present potential violations of ERISA's self-dealing and conflict of interest restrictions. For example, a fiduciary effecting a trade on an ECN on behalf of a plan could be viewed as violating the prohibition against acting on behalf of a party whose interests are "adverse" to the plan (ERISA Section 406(b)(2)) where the fiduciary is reasonably certain that such other party will be on the "other side" of the plan's transaction. Because the new exemption provides relief for any transaction "involving" a purchase or sale of securities through an ECN, the exemption probably should be construed to provide such relief. Because a fiduciary's client accounts are only rarely parties in interest with respect to each other, however, and because the exemption by its terms is applicable only to purchases and sales between a plan and a party in interest, it is not clear whether this interpretation will prevail.

Transactions Involving Service Providers and Their Affiliates

New ERISA Section 408(b)(17) permits a plan and a person that is a party in interest solely because it provides services to the plan, or solely because of a relationship to a service provider that makes the person a party in interest, to engage in the following transactions with the plan, as long as the plan pays no more (or receives no less) than "adequate consideration":

- Sale, exchange, or lease of any property;
- Loan or other extension of credit; and
- Transfer of plan assets to, or use of plan assets for the benefit of, the service provider or affiliate.[4]

---

[4] Although Section 406(a)(1)(C) of ERISA prohibits the provision of services between a plan and a party in interest, Congress presumably concluded that the existing statutory exemption for service arrangements between plans and parties in interest afforded by Section 408(b)(2) adequately addresses the provision of services.

For purposes of the new exemption, "adequate consideration" means:

(i) in the case of a security for which there is a generally recognized market—

(I) the price of the security prevailing on a national securities exchange, taking into account factors such as the size of the transaction and marketability of the security, or

(II) if the security is not traded on a national securities exchange, a price not less favorable to the plan than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and of the party in interest, taking into account factors such as the size of the transaction and marketability of the security, and

(ii) in the case of an asset 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 fiduciary in accordance with regulations prescribed by the Secretary of Labor.

This definition largely replicates the existing definition of "adequate consideration" in Section 3(18) of ERISA.

Impact

The new exemption is potentially very broad and should prove to be useful to permit a number of otherwise prohibited transactions that have little or no potential for abuse. Financial institutions that for one reason or another are unable to use the QPAM exemption may be able to use the new exemption as an alternative in many circumstances.

Nevertheless, the new exemption presents certain interpretive issues that may need to be addressed. Among them is the issue discussed above regarding the treatment of fiduciaries involved in block trades —*i.e.*, is the exemption applicable to a service provider who is a plan fiduciary but who does not act on behalf of the plan with respect to the transaction in question? How this question is answered will have a significant impact on the practical utility of the exemption.

Similarly, the exemption raises a question as to how the adequate consideration requirement should be applied to transactions not involving purchases or sales of securities or other property. The definitions of "adequate consideration" in the Act, ERISA Section 3(18), and the DOL's long-standing, but never-issued, proposed regulation on the subject focus on the valuation of securities or property that is bought, sold, or leased. The definitions work well in those contexts and should be readily adaptable to loans or credit relationships, but it is not clear how the definitions would apply to an otherwise prohibited "transfer" or "use" of plan assets involving a party in interest.

Foreign Exchange Transactions

New ERISA Section 408(b)(18) permits plans to engage in foreign currency transactions in connection with securities transactions. Many plans routinely acquire foreign securities or investments, but such transactions frequently require currency exchanges, which the DOL has characterized as involving prohibited sales or exchanges of property if they occur between plans and parties in interest. Although the DOL has issued two class exemptions to permit foreign currency exchanges (PTE 94-20 and PTE 98-54), many industry participants find the conditions of these exemptions onerous and, accordingly, typically rely on the QPAM Exemption to engage in foreign currency transactions.

The new exemption permits "any foreign currency transaction" between a plan and a party in interest (including a fiduciary) that is a bank or broker-dealer (or affiliate of either) if:

- the foreign exchange transaction is in connection with the purchase, holding or sale of securities or other investment asset;
- the terms of the transactions are not less favorable to the plan than terms in generally comparable arm's-length foreign exchange transactions between unrelated parties; and
- the exchange rate used in the transaction does not deviate by more or less than 3% from the interbank rate for comparable transactions as displayed by an independent service that reports foreign currency exchange rates.

The new exemption *does not apply*, however, if the bank or broker-dealer (or affiliate) has investment discretion or provides investment advice with respect to the transaction.

Impact

Depending on how it is construed, the new exemption should prove exceptionally useful to banks and broker-dealers that provide non-discretionary services to plans. The principal problem with the existing class exemptions relating to foreign exchange transactions has been that they provide only limited relief for the execution of foreign exchange transactions pursuant to "standing instructions."[5] Although the new exemption does not require instructions or directions, the bank or broker-dealer must be in a position to implement the required procedures. This may, as a practical matter, require some sort of disclosure to an independent plan fiduciary, if not an agreement or understanding between the bank or broker-dealer and such fiduciary.

Cross Trades

New ERISA Section 408(b)(19) permits cross trades of securities between a plan and one or more other accounts managed by the plan fiduciary directing the transaction if certain conditions are satisfied. The DOL has long taken the view that cross trades, particularly discretionary cross trades, necessarily violate ERISA's prohibition against a fiduciary acting on behalf of both a plan and another party in the same transaction.[6] The DOL previously issued two class exemptions that permitted, subject to numerous conditions, "agency" cross trades (PTE 86-128) and "passive cross trades," *i.e.*, transactions generated by fixed computer models or changes in market indices (PTE 2002-12), but has generally resisted industry efforts to permit cross trades on a discretionary basis.

The new exemption permits discretionary cross trades of securities if the following conditions are satisfied:

- The cross trade involves a purchase or sale of securities for which market quotations are readily available.
- There is no consideration other than cash payment against prompt delivery.
- The transaction is effected at the independent current market price of the security (within the meaning of SEC Rule 17a-7(b)).
- No brokerage commission, fee (other than previously disclosed transfer fees customary in the industry), or other remuneration is paid in connection with the cross trade.
- A fiduciary for each plan participating in the cross trade (other than the investment manager) authorizes the cross trade in advance and after receiving disclosure regarding the conditions under which cross trades may take place. The disclosure and authorization must be in documents separate from any other disclosure or written agreement involving the asset management relationship. The disclosures must include written policies and procedures of the investment manager regarding cross trades.
- Plans participating in cross trades must have at least $100 million in assets, although plans participating in a master trust for employers in the same controlled group may participate as long as the master trust has at least $100 million in assets.
- The investment manager must provide the authorizing plan fiduciary with a quarterly report detailing all cross trades including the identity of securities bought and sold, the number of units sold and traded, the parties involved in the cross trade, trade price, and the method used to establish trade price.
- The investment manager's fees and agreement to provide services cannot be related to or conditioned on consent to participate in a cross trading program.
- The investment manager must adopt written cross trading policies and procedures that are fair and equitable to all its client accounts. The policies must include a description of the manager's pricing policies and procedures, and allocation policies, and must be in effect at the time of the cross trade.

---

[5] For example, the current exemptions permit foreign exchange transactions pursuant to standing instructions only in amounts up to $300,000.

[6] *See* ERISA Section 406(b)(2). Section 4975(c) of the Code does not include a parallel prohibition. However, because cross trades might involve an exchange of property between a plan and a party in interest, the Act adds the new exemption to both ERISA and Section 4975 of the Code.

- The investment manager must designate a compliance officer responsible for reviewing purchases and sales and compliance with its policies. That person must issue an annual written report not later than 90 days after the period to which it relates (*e.g.*, approximately March 31 for a calendar year). The report must be issued under penalty of perjury to the authorizing fiduciaries and must describe the steps performed during the review, the level of compliance and specific instances of non-compliance. This report must also inform the authorizing fiduciaries of their right to terminate participation in the cross trading program at any time.

  Impact

  The new exemption advances the ball on cross trading somewhat, but involves what appear to be burdensome conditions (*e.g.*, the annual compliance report under "penalty of perjury"). These conditions also differ in certain respects from SEC rules on cross trading. In any case, investment managers will have to determine whether the potential benefits of cross trading outweigh the compliance costs, which may be incremental in some cases and significant in others.

Correction of Prohibited Transactions

New ERISA Section 408(b)(20) provides a limited exemption for certain transactions involving securities or commodities that are corrected within 14 days of the date of "discovery." The new exemption applies to:

- any transaction "in connection with the acquisition, holding or disposition" of a security or commodity (as defined in Section 475(c)(2) of the Code) that would otherwise constitute a prohibited transaction involving a party in interest; and
- that is "corrected" within the 14-day period beginning on the date the party in interest or other person participating in the transaction discovers, or reasonably should have discovered, that the transaction was a prohibited transaction.

For this purpose, "correct" means to (i) undo the transaction to the extent possible and in any case "make good to the plan or affected account" any losses resulting from the transaction and (ii) "restore to the plan or affected account any profits made through the use of the assets of the plan."

There are a number of significant limitations on the applicability of the new exemption. The exemption *does not apply* if:

- at the time of the transaction, the fiduciary, party in interest, or other person knowingly participating in the transaction knew, or reasonably should have known, that the transaction was otherwise a prohibited transaction;
- the transaction involves employer securities or employer real property; or
- the transaction involves fiduciary self-dealing or a conflict of interest prohibited under Section 406(b) of ERISA or Section 4975(c)(1)(E) or (F) of the Code.

  Impact

  The exemption may provide a helpful self-correction mechanism in certain circumstances, particularly for parties in interest other than service providers (who may be able to rely on other new exemptions described above). Further, the exemption compares favorably with the DOL's "Voluntary Fiduciary Correction Program." Although the Program permits correction without penalty of certain prohibited transactions, its scope is limited and involves a formal administrative process with the attendant costs and time frames typical of such processes.

Despite the potential importance of the correction exemption, there are limitations and interpretive issues that may limit its utility. For example, the exemption applies only to transactions in securities or commodities (other than employer securities) that do not involve fiduciary self-dealing or conflict of interest. Moreover, the exemption appears intended to apply only to truly inadvertent prohibited transactions, *i.e.*, those in which none of the parties (not just the party directing the transaction) knows or has reason to know the transaction is prohibited. This condition presents a number of questions. For example: What degree of knowledge that the transaction is prohibited will preclude reliance on the exemption? What degree of knowledge is required to "discover" that the transaction is prohibited and start the 14-day correction period? When "should" a

prohibited transaction reasonably have been discovered? How does legal advice affect a party's knowledge or discovery of the prohibited transaction?

In short, the correction exemption may prove to be a useful way to cure certain inadvertent prohibited transactions. However, parties to a securities or commodities transaction should not enter into the transaction without considering and resolving potentially applicable prohibited transaction issues on the assumption that they will be able simply to correct the transaction if it later proves to have been prohibited.

BONDING REQUIREMENT CHANGES

Relief for Broker-Dealers

The Act provides relief from the fidelity bond requirements of Section 412 of ERISA for SEC-registered broker-dealers that are subject to the fidelity bond requirements of a self-regulatory organization. Prior to the Act, ERISA required each plan fiduciary and other person who handles plan assets to be bonded but exempted trust and insurance companies from that requirement, under certain conditions.

Increased Bond Limits

Before the Act, each person subject to the bonding requirement had to be covered by a bond in an amount equal to at least 10% of the plan assets handled by such person, with a minimum bond amount of $1,000, and a maximum of $500,000.

The Act raises the maximum bond amount to $1,000,000 for a plan that holds employer securities, regardless of whether a bonded person actually handles employer securities. Although a "technical explanation" states that Congress did not consider a plan to hold employer securities if it owns them through a broadly diversified fund, the scope or effect of this indication is unclear. The technical explanation refers to mutual funds and index funds. However, mutual are registered investment companies, and ERISA has always provided that registered investment funds do not hold plan assets, so the explanation is unnecessary if it refers to registered investment companies. If the reference to index funds is intended to mean unregistered funds if any such fund is a "plan asset" fund, such as a hedge fund in which plan investment is significant, nothing in the text of the Act suggests that the increased bonding requirement does not apply to plans that invest in "plan asset" funds or persons who advise such funds.

Kirkpatrick & Lockhart Nicholson Graham has approximately 1,000 lawyers and represents entrepreneurs, growth and middle market companies, capital markets participants, and leading FORTUNE 100 and FTSE 100 global corporations nationally and internationally. Members of the ERISA Fiduciary Group and their telephone numbers and email addresses are listed below. For more information you may also visit our website at www.klng.com.

LOS ANGELES

Alexandra C. Sparling	310.552.5563	asparling@klng.com
William P. Wade	310.552.5071	wwade@klng.com

WASHINGTON

Catherine S. Bardsley	202.778.9289	cbardsley@klng.com
Lori G. Galletto	202.778.9024	lgalletto@klng.com
Brendan S. McParland	202.778.9210	bmcparland@klng.com
David E. Pickle	202.778.9887	dpickle@klng.com
William A. Schmidt	202.778.9373	william.schmidt@klng.com

www.klng.com

BOSTON ▪ DALLAS ▪ HARRISBURG ▪ LONDON ▪ LOS ANGELES ▪ MIAMI ▪ NEWARK ▪ NEW YORK ▪ PALO ALTO ▪ PITTSBURGH ▪ SAN FRANCISCO ▪ WASHINGTON

Kirkpatrick & Lockhart Nicholson Graham (K&LNG) has approximately 1,000 lawyers and represents entrepreneurs, growth and middle market companies, capital markets participants, and leading FORTUNE 100 and FTSE 100 global corporations nationally and internationally.

K&LNG is a combination of two limited liability partnerships, each named Kirkpatrick & Lockhart Nicholson Graham LLP, one qualified in Delaware, U.S.A. and practicing from offices in Boston, Dallas, Harrisburg, Los Angeles, Miami, Newark, New York, Palo Alto, Pittsburgh, San Francisco and Washington and one incorporated in England practicing from the London office.

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

Data Protection Act 1988—We may contact you from time to time with information on Kirkpatrick & Lockhart Nicholson Graham LLP seminars and with our regular newsletters, which may be of interest to you. We will not provide your details to any third parties. Please e-mail london@klng.com if you would prefer not to receive this information.

© 2006 KIRKPATRICK & LOCKHART NICHOLSON GRAHAM LLP. ALL RIGHTS RESERVED.