
Fiduciary Provisions of the Pension Protection Act of 2006

2006-08-04

Late last night, the Senate approved the House-passed version of the Pension Protection Act of 2006 (H.R. 4) (the Act). The Act is expected to be signed by the President within the next two weeks. While the bulk of the legislation addresses issues relating to pension plan funding and under funding, the Act also contains a number of significant and long-awaited changes to the ERISA fiduciary and prohibited transaction rules. This alert summarizes those provisions of special interest to our investment management and financial services clients.

Definition of Plan Asset Vehicle Liberalized

Changes to the plan asset rule will make it easier for United States corporate pension plans, as well as all other benefit plans, to gain access to hedge funds and other pooled investment vehicles, such as funds of funds.

The Act eliminates foreign benefit plans and United States governmental plans (and non-electing church plans) from having to be included in the so-called "25% test." The 25% test is used to determine whether assets of a fund are "plan assets" subject to ERISA. Thus, in applying the 25% test, only United States corporate or union pension plans, IRAs and other plans subject to ERISA or to Code Section 4975 need to be taken into account.

Additional relief is provided in the adoption of a pro rata rule in situations where a "plan assets" vehicle invests in another vehicle, such as a fund of funds. In determining whether a second-tier fund itself holds plan assets in cases where a plan asset first-tier fund invests in a second-tier fund, only the proportional interest of benefit plan investors in the first-tier fund--rather than 100% of the investment--is counted.

The Act essentially codifies the remainder of the Department of Labor (the DOL) regulation's 25% test. An entity shall not be treated as holding plan assets if less than 25% of the total value of each class of equity interest is held by "benefit plan investors" (as modified so as to cover only ERISA and Code Section 4975 plans). Equity interests held by fund managers and affiliates (other than a benefit plan investor) are, as in the regulation, disregarded. *Effective for transactions occurring after the date of enactment.*

Cross Trading Permitted for Large Plans; DOL to Work with SEC to Develop Regulations

The Act permits cross trading (the purchase and sale of a security between a plan and any other account managed by the same investment manager) if:

- The transaction is a purchase or sale for no consideration other than cash against prompt delivery of a security for which market quotations are readily available
- The transaction is at an independent current market price
- No brokerage commission, fee (except customary transfer fee as disclosed to the independent fiduciary authorizing the cross trading) or other remuneration is paid in connection with the transaction
- An independent fiduciary authorizes the cross trading in a separate agreement after receiving separate disclosure
- Each plan has assets of at least \$100,000,000
- There is quarterly reporting of such transactions
- The manager's fee or other services cannot depend on a plan's authorization of cross trading
- The manager has adopted written cross trading policies and procedures. The DOL, after consultation with SEC, is to issue regulations regarding cross trading policies and procedures within 180 days after enactment
- The manager must designate an individual responsible to ensure compliance with procedures, and annual compliance reports must be provided to the plan fiduciary
- The plan fiduciary may terminate the cross trading authorization at any time

Effective for transactions occurring after the date of enactment.

Clarification of Trading over Alternative Trading Networks

A statutory prohibited transaction exemption (PTE) is added for any transaction involving the purchase and sale of securities between a plan and a party in interest over an electronic communication network, alternative trading system or similar execution system subject to regulation and oversight by the "applicable Federal regulating entity" (not defined in the Act). The conditions of the exemption are: (i) either the system matches the best price available in accordance with applicable rules of the SEC or the identities of parties are not taken into account; (ii) the price and compensation associated with the transaction must not be greater than that associated with an arm's length transaction; (iii) if the party in interest has an ownership interest in the exchange, the use of the system must be authorized by the plan sponsor or an independent fiduciary; and (iv) not less than 30 days prior to the initial transaction, a plan fiduciary is provided with notice of the transaction over such system. *Effective for transactions occurring after the date of enactment.*

Provision of Investment Advice to 401(k) and Other Defined Contribution Plan Participants

The Act adds a PTE allowing advisers and other parties in interest to participant-directed account plans, such as 401(k) plans, to provide investment advice to plan participants. The investment advice provided by the fiduciary advisor must be provided under an "eligible investment advice arrangement" and must satisfy other requirements, including appropriate disclosure of the investment advice. An "eligible investment advice arrangement" is an arrangement which either: (i)

provides that fees for the investment advice do not vary depending on the basis of any investment option selected; or (ii) uses a computer model under an "investment advice program" (as defined in the Act). Records of the advice must be maintained for six years. *Effective for transaction occurring after December 31, 2006.*

Exemption from Block Trading

The Act also adds a statutory PTE for a "block trade" purchase or sale of securities (or other property as determined by the DOL) between a plan and a nonfiduciary party in interest if: (i) the interest of the plan in the trade does not exceed 10% of the trade; (ii) the price is at arm's length; and (iii) the compensation is at arm's length. "Block trade" means trades of at least 10,000 shares **or** a trade with a market value of at least \$200,000, which will be allocated across two or more unrelated client accounts of a fiduciary. *Effective for transactions occurring after the date of enactment.*

Bonding Relief for BD; Increase in Bonding for Plans Holding Employer Securities

An exception to the ERISA bonding requirement is provided for registered broker-dealers if the broker-dealer is subject to the fidelity bond requirements of a self-regulatory organization. A second provision of the Act increases the bonding requirement from \$500,000 to \$1,000,000 for plans holding employer stock or other securities. *The broker-dealer exception is effective for plan years beginning on or after the date of enactment and the increase in the bonding amount is effective for plan years beginning after December 31, 2007.*

Exemption for Service Providers

The following transactions between a plan and a nonfiduciary service provider (or such service providers' affiliates) are exempted from the prohibited transaction rules: (i) sales and exchanges; (ii) the lending of money or extension of credit; and (iii) transfers to, or use by or for the benefit of a party in interest, of any assets of the plan. The plan must receive or pay "adequate consideration" as defined. This provision permits many transactions that previously were conducted through a qualified plan asset manager (QPAM) pursuant to PTE 84-14. *Effective for transactions occurring after the date of enactment.*

Relief for Foreign Exchange Transactions

The Act exempts foreign exchange transactions between a bank/broker-dealer and a plan, where the bank/broker-dealer is a party in interest (including a fiduciary other than one that is described in (iv) below), if: (i) the transaction is in connection with the purchase, holding or sale of securities or other investment assets; (ii) at the time the transaction is entered into, the terms of the transaction are not less favorable to the plan than arm's length; (iii) the exchange rate used is +/- 3% from the interbank bid and asked rate for comparable transactions; and (iv) the bank/broker-dealer does not have investment discretion or does not provide investment advice with respect to the transaction. This allows forex transactions to be undertaken in circumstances where the QPAM exemption is not available. *Effective for transactions occurring after the date of enactment.*

Correction of PTs for Securities and Commodities Transactions

The Act adds a statutory exemption for transactions that are described in ERISA section 406(a) in connection with the acquisition, holding or disposition of any security or commodity, if the transaction is corrected before the end of the "correction period." The exemption does not apply to transactions between a plan and plan sponsor involving employer securities or employer real property; nor does it apply if the fiduciary or party in interest knew "(or reasonably should have known)" that the transaction would violate ERISA section 406(a). The "correction period" is the 14-day period following discovery or following the time when the applicable party "reasonably should have discovered" the violation. "Security" is as defined in Code Section 475(c)(2) and "commodity" is defined in Code Section 475(e)(2). To "correct" means to "undo the transaction to the extent possible and in any case to make good to the plan" any losses and to restore to the plan any profits. Parallel excise tax provisions provide for no assessment of tax if the conditions of the exemption are satisfied, and abatement of tax if paid. *Effective date: Applies to any transaction which the fiduciary or party in interest discovers, or reasonably should have discovered, after the date of enactment of this Act constitutes a prohibited transaction.*

Promotes Expansion of Default Funds, Including "Lifecycle Funds"

The Act treats a 401(k) plan's establishment and operation of a default investment fund as eligible for the fiduciary relief provisions of ERISA section 404(c), if certain notice requirements are satisfied. Regulations (to be issued six months after enactment) will provide guidance on the appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both. *Effective for plan years beginning after December 31, 2006.*

Clarification of Fiduciary Rules Applicable to Annuity Distributions from Defined Contribution Plans

Not later than one year after the date of the enactment of the Act, the DOL will issue final regulations clarifying that the selection of an annuity contract as an optional form of distribution from an individual account plan is not subject to the safest available annuity standard under Interpretive Bulletin 95-1, and is subject to all other applicable fiduciary standards. *Effective as of the date of the enactment.*

For more information on this or other securities matters, please contact your regular WilmerHale investment management, broker-dealer, fund formation lawyer or the authors listed above.

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